S. Hrg. 100-507

THE INSIDER TRADING PROSCRIPTIONS ACT OF 1987

HEARING

BEFORE THE

SUBCOMMITTEE ON SECURITIES

OF THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

FIRST SESSION

ON

S. 1380

TO AMEND THE SECURITIES EXCHANGE ACT OF 1934 TO PROHIBIT CERTAIN TRADING OR COMMUNICATIONS BY THOSE WHO POSSESS MATERIAL, NONPUBLIC INFORMATION

DECEMBER 15, 1987

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

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THE INSIDER TRADING PROSCRIPTIONS ACT OF 1987

TUESDAY, DECEMBER 15, 1987

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON SECURITIES,
Washington, DC.

The subcommittee met at 10 a.m., in room SD-538, Dirksen Senate Office Building, Senator Donald W. Riegle, Jr. (chairman of the subcommittee) presiding.

Present: Senators Riegle, Proxmire, Hecht, and Bond.

OPENING STATEMENT OF SENATOR RIEGLE

Senator RIEGLE. The Securities Subcommittee will come to order.

We are very pleased today to have the Chairman of the SEC appearing before us. Before I make a beginning statement let me just say to Chairman Ruder that you certainly arrived on the scene at a very dramatic and difficult moment with respect to our securities markets. We have had the occasion to work together now on a number of items, including the difficulties surrounding October 19 and other things such as insider trading, and I want to just say for the record that I appreciate very much the leadership you have shown in this job under very difficult circumstances.

It seems to me that you have stepped forward in a number of critical areas, that you have been very direct and forceful in your comments and your leadership efforts, and that's precisely what is needed. People may agree or disagree with each and every position or statement, but certainly this is the time for strong, thoughtful leadership such as you are providing. I appreciate that fact and I think it's very important to the country at this time.

Today, we are holding our fourth hearing relating to legislation on insider trading. Last month, the U.S. Supreme Court provided Congress with another compelling reason to clarify and define the law in this area by written statute. On November 16, in *Carpenter* v. *United States,* better known as the *Winans* case, the Court split right down the middle with a four-to-four vote with respect to Winans' conviction under the securities laws.

That to me is a clear indication that even our highest Court in the land is uncertain about the scope of insider trading under today's securities laws. And no wonder. Strange though it may seem, insider trading, as such, is not now specifically prohibited by Federal statute. The law on insider trading has developed from the

general antifraud provisions of the Securities and Exchange Act of 1934.

Unfortunately, the courts have not interpreted fraud as it relates to insider trading with any degree of consistency or clarity. As a result, not even lawyers, let alone members of the public, can be sure from one court case to another what the state of the law actually is in this area. Or for that matter, even where to find out what the law is likely to be in the future. I think that's really an unacceptable situation and has to be changed.

This has resulted in many other calls for change. For example, just one home State newspaper in Michigan, the Herald Paladium in St. Joseph, MI, recently wrote an editorial—and I want to quote them—this editorial ran on November 27, 1987. The editorial was captioned "Insider Trading Law Suffers from Haziness." And it concluded this way, and I quote them:

> The haziness in the securities laws on what is and is not insider trading should be erased. So far, the courts have declined to assume that role. The same is true for Congress, which has the first responsibility to act.

I fully agree the courts ought not to write the law alone in this area. That's really our job and we should step up to it.

On June 17, 1987, Senator D'Amato and I introduced S. 1380, the Insider Trading Proscriptions Act of 1987. This legislation was drafted at our request by an ad hoc legislative committee of outstanding securities lawyers which Senator D'Amato and I asked be formed for that task.

I am tremendously encouraged by the widespread support we have received for our proposal. Former SEC Acting Chairman Charles Cox, as well as the head of the SEC Division on Enforcement, have already testified that S. 1380 would be preferable to the current law and today we will hear again from the Securities Industry Association that with minor modifications they endorse S. 1380.

Meanwhile, Chairman Ruder has worked very closely with us and will testify today with respect to further refinements he believes should be made within the general context of the Insider Trading Proscriptions Act.

So I want to thank you again, Chairman Ruder, for the leadership that you've given on this and I think that with your continued help and that of our ad hoc legislative committee and others we will be able to move forward shortly on this legislation.

Finally, you know of my very strong interest in ensuring that the Commission receives the funding necessary for the SEC to do its job well—particularly under the pressures of the extraordinary circumstances in the financial markets at this time. Any comments which you have with respect to the issue of the funding for the agency I would encourage you to feel free to make. I will want to pursue that in any event in my own questioning when the time comes.

We have a fine group of witnesses with us this morning and we're going to benefit very much from their testimony. So let me now yield to Senator Bond and then to Chairman Proxmire.

OPENING REMARKS OF SENATOR BOND

Senator BOND. Thank you, Mr. Chairman.

I just want to welcome Mr. Ruder and say that we are very pleased, as Chairman Riegle has indicated, that we will have a very good discussion today of the complex legislation that we are considering. We thank you for your efforts and we look forward to hearing your testimony.

Senator RIEGLE. Thank you, Senator Bond.

Senator Proxmire.

OPENING REMARKS OF SENATOR PROXMIRE

Senator PROXMIRE. Thank you, Mr. Chairman.

I certainly want to second what you said about Mr. Ruder's fine start. At a time when we have real problems of course in our securities markets, I think he's given us leadership and confidence.

I have had a chance to look over the statements by the witnesses this morning and I'm very impressed. I think they are excellent statements. They are on an issue which is of the greatest importance to the country—the integrity of our capital markets from insider trading is certainly challenging and they are coming at a time when the markets are erratic and volatile and I agree with the Chairman that not only do we need the kind of leadership you are giving on the administrative front, but I think that Congress has a job in this particular area where we should proceed and proceed vigorously.

Mr. Chairman, I want to commend you on the hearing and I want to commend the witnesses on their fine statements.

Senator RIEGLE. Thank you, Chairman Proxmire. I have found over the years when Chairman Proxmire decides that something is important and needs to be done, the chances of it happening are much greater. So I'm delighted that we share that view on the need to get this law clarified and tightened and I think it will help us put a stop to some of the abuse that we have seen and clearly that is its striving purpose, so that people that want to stay within the law can do so clearly knowing what the law is, and those that break the law that we can find them and bring them to justice and to punish them appropriately.

Senators Sasser and Sanford have statements for the record, so without objection, we will insert their remarks at this point.

OPENING STATEMENT OF SENATOR JIM SASSER

Senator SASSER. Mr. Chairman, I am pleased that the subcommittee is continuing its progress towards legislating a definition of insider trading. The witnesses you have assembled today, particularly the SEC, have made many important comments that will help us in our efforts.

Mr. Chairman, I am concerned about the progress of the SEC's insider trading enforcement effort. I am interested in finding out to what extent the cloud over the law in this area has affected, if at all, the SEC. I think that is important to get the insider trading controversy, that has developed on Wall Street over the past 2 years, behind us as soon as possible. If enacting your legislation will help, we should do that soon.

We need to begin to restore the perception of our stock market among the general public as a fair place to invest for the long term. I think too many people look at it now as a place where insiders have an advantage, and as a place to get rich quick by speculation or market manipulation. I understand that Hollywood, with a movie called "Wall Street," may be furthering that impression.

Mr. Chairman, I again compliment you and Senator D'Amato on your effort. Thank you.

OPENING STATEMENT OF SENATOR TERRY SANFORD

Senator SANFORD. Mr. Chairman, I commend you for your fine leadership on the many issues this committee is considering, including the important topic of this morning's hearing—how to define insider trading. I praise your efforts in assembling before us the key policy, financial, and legal representatives to guide us in our work to clarify and define the law on insider trading.

We are fortunate to have the testimony today of a diverse and knowledgeable panel of witnesses. David Ruder, Chairman of the Securities and Exchange Commission, has appeared before us on numerous occasions and I would like to thank him for his cooperation and for the contributions he has made to the efforts to come up with a workable definition of insider trading.

I would also like to extend a special welcome to James Cox, professor of law at Duke Law School. As a former president of Duke University, I am delighted to hear him speak to us this morning. Professor Cox is especially well qualified to testify on insider trading as he is a specialist in corporate and securities law and author of a book on the use of financial information and the regulation of public corporations.

Clearly, insider trading is an abuse of the financial system that needs to be dealt with once and for all, not only for the sake of the securities industry but for the sake of restoring public confidence in the integrity of the financial markets. Yet, despite all the compelling reasons why we need reform and increased regulation, it is a problem that has no easy quick fixes. We have seen that the difficulty of arriving at a definition, is in large measure an obstacle to finding mechansims of addressing it. The Pitt Commission took great strikes in this regard and I appreciate their work in furthering the progress of this subcommittee. I am encouraged by the efforts of Senators Riegle and D'Amato to cope with the broad scope of insider trading with S. 1380, the Insider Trading Proscriptions Act of 1987. This bill was the culmination of the work of a group of prominent securities lawyers at the request of this subcommittee. In response, the SEC drafted a "compromise bill" in the form of a letter to the subcommittee. I look forward to hearing from today's witnesses on the strengths and weaknesses of the two versions of the bill under discussion. Thank you.

Senator RIEGLE. With that, Chairman Ruder, we would be pleased to hear from you now.

[Copy of proposed bill S. 1380 follows:]

100TH CONGRESS
1ST SESSION

S. 1380

To amend the Securities Exchange Act of 1934 to prohibit certain trading or communications by those who possess material, nonpublic information.

IN THE SENATE OF THE UNITED STATES

JUNE 17, 1987

Mr. RIEGLE (for himself and Mr. D'AMATO) introduced the following bill; which was read twice and referred to the Committee on Banking, Housing, and Urban Affairs

---

A BILL

To amend the Securities Exchange Act of 1934 to prohibit certain trading or communications by those who possess material, nonpublic information.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Insider Trading Proscriptions Act of 1987".

SEC. 2. INSIDER TRADING PROSCRIPTIONS.

Chapter 78 of title 15, United States Code, is amended, by adding at the end of section 78p the following:

"§ 16A.

"(a) FINDINGS.—

"(1) The fairness, honesty, and integrity of the Nation's securities markets are impaired when corporate insiders and other persons who obtain material, nonpublic information relating to a particular security or group of securities (or the market for such security or group of securities) wrongfully use that information, or wrongfully communicate that information to others who misuse it, in connection with the purchase or sale of any security.

"(2) Effective prohibitions against trading by persons who wrongfully use material, nonpublic information, and wrongfully communicate that information to others who misuse it, are necessary to preserve the integrity of our markets and their ability to serve important national and international economic functions, including capital formation.

"(3) There is an important public interest in the prompt, unfettered flow to the securities markets of information.

"(4) The specific delineation of what constitutes the wrongful use or wrongful communication of material, nonpublic information provided herein is necessary to promote greater clarity in the law.

"(b) Prohibition Against the Use of Material, Nonpublic Information.—

"(1) It shall be unlawful for any person, directly or indirectly, to use material, nonpublic information to purchase or sell any security, by the use of any means or instrumentalities of interstate commerce, or of the mails, or of any facilities of any national securities exchange, or of any automated quotations system maintained for the trading of securities, if such person knows or is reckless in not knowing that such information has been obtained wrongfully, or if the purchase or sale of such security would constitute a wrongful use of such information. For the purposes of this section, information shall have been used or obtained wrongfully only if it has been obtained by, or its use would constitute, directly or indirectly, theft, conversion, misappropriation or a breach of any fiduciary, contractual, employment, personal or other relationship of trust and confidence.

"(2) For purposes of subsection (b)(1), any person who purchases or sells a security while in possession of material, nonpublic information relating to that security (or the market therefor) shall be presumed to have used that information in connection with such purchase or sale. Notwithstanding the foregoing, in the case of a

person other than a natural person, the presumption that such material, nonpublic information in that person's possession was used in connection with transactions in that security shall be overcome if such person sustains the burden of proving that—

"(A) the purchase or sale of the security was not influenced by such material, nonpublic information; and

"(B) the individual effecting the purchase or sale, or causing others to purchase or sell, on behalf of such person, did not know the material, nonpublic information.

In determining whether any person other than a natural person has sustained its burden of proof under this subsection, it shall be relevant whether, and to what extent, such person has implemented and maintained reasonable policies and procedures to prevent violations of this section by the individuals making or influencing investment decisions on its behalf.

"(c) PROHIBITIONS AGAINST THE WRONGFUL COMMUNICATION OF CERTAIN MATERIAL, NONPUBLIC INFORMATION.—

"(1) It shall be unlawful for any person, directly or indirectly, wrongfully to communicate material, nonpublic information to another person who, directly or

indirectly, purchases or sells any security that is directly or indirectly the subject of the communication, while in possession of such information, if the person making the communication knows (or is reckless in not knowing) that such information would be used for a purchase or sale of a security that would violate subsection (b) of this section.

"(2) It shall be unlawful for any person planning an acquisition or disposition of an issuer, a material block of the issuer's securities or its assets, or any person acting on behalf of such a person (herein the 'transacting person'), for the purpose of influencing or encouraging the purchase or sale of the securities of such issuer, to communicate, directly or indirectly, material, nonpublic information concerning such plans to any other person who thereafter purchases or sells the affected securities, unless such other person is acting on behalf of or as part of a group with the transacting person (within the meaning of section 13(d)(3) of this title) or the communication of such information has been made in the course of a good faith solicitation of such other person to act on behalf of or as part of a group with the transacting person (within the meaning of section 13(d)(3) of this title) or the securities are ac-

quired directly from or sold directly to the transacting person.

"(d) DERIVATIVE LIABILITY.—No person shall be liable under this section solely by reason of the fact that such person controls or employes a person who has violated this section, if such controlling person or employer neither participated in, nor directly or indirectly induced the acts constituting the violation of this section.

"(e) COMMISSION RULEMAKING AND ORDERS.—The Commission may, by rules consistent with the provisions of this section, implement the provisions of this section. The Commission, by rules, or by order, may exempt any person, security or transaction, or any class or classes of persons, securities or transactions, from any provision or provisions of this section, if and to the extent that such exemption is consistent with the provisions of this section.

"(f) PRIVATE RIGHTS OF ACTION.—Any person who is injured by a violation of this section in connection with the purchase or sale of any security may recover any damages sustained by reason of such violation. For the purpose of this section, a person shall be deemed to have been injured by a violation of this section if such person has purchased or sold the affected securities contemporaneously with the transactions in such securities that form the basis of the violation of paragraph (b) or (c) of this section. No person shall be liable

in damages in any action under this subsection for an amount in excess of such person's actual profit obtained or loss avoided. Any damages imposed against any person under this subsection shall be diminished by (and, where available, recovered from) the amounts, if any, that such person may be required to disgorge, pursuant to a court order obtained at the instance of the Commission, in a proceeding brought under section 21(d) of this title relating to the same transaction or transactions. Any person who violates subsection (c) of this section shall be liable, jointly and severally, to the same extent as any persons who obtained profits or avoided losses as a result of such violations of subsection (c). The period of limitations for the commencement of any action under this subsection shall be the same as that provided in section 21(d)(2)(D) of this title (the Insider Trading Sanctions Act).

"(g) Exclusivity.—This section shall provide the exclusive standards by which the wrongful use or wrongful communication of material, nonpublic information in connection with the purchase or sale of a security shall be addressed. This section shall not, however, affect other prohibitions or requirements of law based, in whole or in part, on conduct other than such wrongful use or wrongful communication of material, nonpublic information.".

SEC. 3. EFFECTIVE DATE.

This Act shall take effect immediately upon enactment of this Act.

STATEMENT OF DAVID S. RUDER, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Mr. RUDER. Chairman Riegle and members of the subcommittee: I am particularly pleased to be here today to testify concerning the Commission's revised proposal to define and prohibit insider trading. I ask that my written statement previously submitted to the subcommittee be included in the hearing record.

Senator RIEGLE. It will be done.

Mr. RUDER. At the outset, I would like to commend the subcommittee for its important leadership in working toward legislation to define and prohibit insider trading. Additionally, let me note my concurrence with those who continue to support a statutory definition even after the Supreme Court's decision in *United States* v. *Carpenter*. The Court's decision in that case was an important victory for the Government and for the Commission since it leaves standing the 2nd Circuit's affirmance of the misappropriation theory. Nevertheless, the Commission continues to support insider trading legislation in order to promote clarity and certainty in the law.

Prior to my becoming Chairman of the Securities and Exchange Commission, Chairman Riegle asked Harvey Pitt to form an ad hoc committee to draft insider trading legislation. The work of this ad hoc committee resulted in proposed legislation introduced by Chairman Riegle and Senator D'Amato previously referred to, S. 1380, introduced in June of this year.

At the subcommittee's request, the Commission submitted its own proposal for a statutory definition in early August. One of my first tasks when I became Chairman was to work through the Commission's staff with members of the ad hoc committee to produce a reconciliation draft between the draft submitted by the Commission in August and S. 1380, which could then be submitted to the subcommittee.

As a result of these efforts, the Commission has submitted a revised legislative proposal to the subcommittee on November 18. The Commission's proposal differs in only one significant respect from the reconciliation draft submitted by members of the ad hoc committee.

The Commission's support for its proposal depends in part upon the development of proposed legislative history which will amplify and describe certain provisions contained in its proposal. The Commission hopes shortly to submit that proposed legislative history to the subcommittee for its consideration.

I should note as important that the Commission's proposal has been formally adopted by the Securities and Exchange Commission, the agency charged with administration of the Nation's securities laws, and therefore represents the policy of that agency.

The Commission's written testimony sets forth at some length the provisions in the Commission's proposal. Let me highlight just a few of them.

THEFT OF INFORMATION

First, it utilizes a wrongfulness approach in the general trading prohibition that reaches the theft of information and the use of

confidential information. It includes the terms "misappropriation and conversion," which are soundly based upon breach of duty theory. No violation will exist under our proposal unless the person knows or recklessly disregards that the information has been obtained wrongfully or that the purchase or sale would constitute a wrongful use.

Second, the Commission's proposal prohibits trading while in possession of material nonpublic information. The Commission rejects requiring the use of such information for trading since the use test makes enforcement extremely difficult. The possession test, which we advocate, is not harsh in view of the knowing or reckless disregard standard which appears in the general provision.

Third, the proposal contains a general tipping prohibition that expressly imposes liability based upon reasonably foreseeable trading.

Fourth, the proposal creates private rights of action for contemporaneous traders and additionally for other persons who can prove that they have been injured in their securities transactions by the insider trading violation.

Fifth, although the proposal does not contain an express exemption for communications made by or to analysts, it offers substantial protection for good faith communications. The Commission recognizes that an insider trading bill may interfere with the important analyst function of disseminating information to the market. To ensure that the analyst function is not impaired by the proposed legislation, the Commission's proposal contains both a wrongfulness concept and a foreseeability provision in the general tipping prohibition. An analyst must know that information has been communicated to him in a breach of duty, or the analyst must himself violate his duty in communicating the information.

The proposal contains a provision pursuant to which the Commission would have authority to exempt certain persons from the provisions of the bill. This provision is of particular importance to the Commission which anticipates, for example, that it will use the exemptive authority to exempt certain communications to and by market analysts that are consistent with the purposes of the act.

POSSESSION OF CONFIDENTIAL INFORMATION

Finally, as I noted earlier, there is only one substantive area in which the Commission differs from the ad hoc committee. That area concerns communications relating to a person's own plans to acquire an issuer. The Commission's proposed legislation would continue existing law by generally codifying Commission rule 14e–3, a rule that makes it unlawful to trade while in possession of material nonpublic information relating to a tender offer. This provision does not depend upon wrongful conduct. By contrast, the ad hoc committee would extend the nonfault provisions to any acquisition or disposition of an issuer or a material portion of the issuer's securities or assets.

The Commission believes that Congress should endorse the approach of rule 14e–3. Experience has shown that trading and the potential for trading while in possession of confidential information relating to tender offers can result in significant market disruption

and abusive practices. However, the Commission does not believe that there has been a demonstration that similar express prohibitions are necessary for other types of transactions. In most cases that will arise involving transactions other than tender offers, the persons obtaining material nonpublic information will owe duties of confidentiality; and, thus, their trading or tipping would be prohibited by the general trading and tipping proscriptions in the Commission's proposal, and a nonfault provision is not necessary in that regard.

Mr. Chairman, the task which you and this subcommittee have undertaken is an important and challenging one, and I look forward to continuing to work with this subcommittee in its efforts to develop insider trading legislation.

If I may, Mr. Chairman, I would like to respond to your question regarding Commission resources.

Senator RIEGLE. Please do.

Mr. RUDER. Between 1980 and 1987, the securities markets experienced phenomenal growth. For example, trading volume on U.S. securities markets during that period more than quadrupled. During that same period, registered brokers increased from 6,750 to 13,000. The number of investment advisers increased from 4,580 to 13,000. The number of investment companies increased from 1,461 to 3,300. And the number of initial public offerings increased from 710 to 2,220.

Additionally, during that period, the enforcement efforts of the Commission have increased markedly.

Nevertheless, during these same years, from 1980 to 1987, the Commission's personnel resources shrank by 111 staff years, from 2,041 to 1,930. At present, in addition to the Commission's ongoing regulatory responsibilities, it is engaged in a series of major initiatives relating to strengthening the integrity of our capital markets. Those include not only the insider trading and other enforcement efforts, but also internationalization of the securities markets, and analysis of the causes and implications of the October market break.

President Reagan has recommended a fiscal year 1988 Commission budget of $145 million, a significant increase over the Commission's $114.5 million 1987 appropriation. Both the Senate and the House have passed appropriations approximating $142 million. An appropriation in this range, while still not ideal, would permit the Commission to keep pace with the increasing scope of its responsibilities. It would also continue the Commission's status as a Government profit center, since $142 million of spending would only absorb approximately ½ of the fee revenues generated by the Commission.

I am, however, deeply concerned that as a result of the ongoing budget negotiations, the Commission's 1988 appropriation may be significantly less than the President's request—funding which would result in a level of Commission activity, as we understand mandatory expenditures which we must make, at or below 1987 levels. This level would be extremely unfortunate in light of the dramatic growth of our responsibilities.

For these reasons, I urge that the 1988 budget legislation appropriate at least $142 million for the Commission and that the Com-

mission be authorized to reprogram certain funds appropriated for certain purposes to other pressing agency obligations.

Chairman Riegle, I appreciate the opportunity to address these budget considerations. I recognize that my suggestions in this regard represent somewhat of a deviation from my predecessor's, but I would tell you that I came to the Commission and found a Commission which is well-staffed and able to meet its regulatory duties. The problem is that we have now reached the limit of our ability to deal with the expanded securities markets and the matters which are before us, and it is essential that we be able to expand our resources in order to meet our new responsibilities.

Thank you.

[The complete prepared statement of David S. Ruder follows:]

STATEMENT OF DAVID S. RUDER,
CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION,
BEFORE THE SUBCOMMITTEE ON SECURITIES OF THE
SENATE BANKING, HOUSING AND URBAN AFFAIRS COMMITTEE

CONCERNING THE COMMISSION'S REVISED PROPOSAL
TO DEFINE INSIDER TRADING

December 15, 1987

Chairman Riegle and Members of the Subcommittee:

The Securities and Exchange Commission is pleased to testify concerning its revised proposal for a statutory definition of insider trading, which was transmitted to the Subcommittee on November 18, 1987 The Commission's Proposal would expressly define and prohibit insider trading through provisions carefully crafted to preserve and protect the fairness, integrity, and efficiency of the nation's securities markets This statement describes the Commission's Proposal, discusses significant differences between that proposal and S. 1380, legislation introduced on June 17, 1987 by Chairman Riegle and Senator D'Amato, and discusses the one substantive difference between the Commission Proposal and the "Reconciliation Draft" recently submitted by Harvey L. Pitt, Chairman of the Ad Hoc Legislative Committee to Define Insider Trading (the "Ad Hoc Committee").

I. <u>Background</u>

During an oversight hearing before the Subcommittee on February 24, 1987, Chairman Riegle requested Harvey Pitt to form a committee of securities law practitioners to draft statutory language to define and prohibit insider trading. The work of this group, the Ad Hoc Committee, resulted in proposed legislation that was introduced by Chairman Riegle and Senator D'Amato as S. 1380, the "Insider Trading Proscriptions Act of 1987," on June 17, 1987.

The Commission testified before the Subcommittee on June 19, 1987, concerning the desirability of a statutory definition of insider trading, and in particular, the merits of the approach adopted in S. 1380. In general, the Commission stated that it could support a definition that preserved its authority and flexibility, although it did not believe a statutory definition was necessary for the continued success of its enforcement program. With respect to S. 1380, the Commission stated that, although there was much in the bill that the Commission could endorse, it could not recommend adoption of the proposed legislation due to concerns about certain of its provisions. Therefore, the Commission stated that it would develop and submit to the Subcommittee its own proposal for a statutory definition of insider trading.

The Commission submitted its original proposal for a definition on August 3, 1987, and the Subcommittee held hearings on this proposal on August 7, 1987. At that hearing, and thereafter by letter, the Subcommittee requested that the Commission assist in the process of developing a consensus proposal for legislation defining insider trading. In response to that request, member of the Commission's staff met with representatives of the Ad Hoc Committee to discuss a potential compromise. Following those meetings, and as a result of further Commission consideration of the definition, the Commission acting by majority determined that could support legislation that differs in certain respects from the Commission's original proposal and includes certain provisions adopted from S. 1380. On November 18, 1987, the Commission submitted to the Subcommittee its revised proposal for compromise legislation. 1/ It bears emphasis that, although the Commission's Proposal differs from the Ad Hoc Committee's in only a few areas, the Commission's endorsement extends only to its own proposal.

II. <u>Purpose of the Commission's Proposal</u>

The law of insider trading has developed pursuant to judicial and administrative decisions construing the antifraud provisions of the federal securities laws, especially Section 10(b) of the Securities Exchange Act and Rule 10b-5. Under this body of law, "insider trading" refers generally to the act of purchasing or selling a security in breach of a fiduciary duty or other relationship of trust and confidence while in possession of material

1/ Chairman Ruder letter of November 18 1987 transmitting the Commission Proposal, stated that the proposal would be acceptable to the Commission provided that certain interpretive positions are clearly set forth in the legislative history. (A copy of tha letter is attached as Appendix A.) Chairman Ruder's letter set forth those areas in which the Commission believed clarifying legislative istory was necessary and indicated that the Commission's staf had been requested to prepare suggested Committee Repor language addressing these issues This repor language will be transmitted to the Subcommittee as soon as it is completed.

Commissioner Grundfest's position on the Commission's Proposal is contingent on his approval of this legislative history. Commissioner Fleischman did not join n accepting the proposed legislation or the proposals for legislative history.

nonpublic information relating to that security. The law prohibits such trading by corporate officers and directors and other persons having a relationship of trust and confidence with the issuer or its shareholders. 2/ Under a theory developed in the Second Circuit Court of Appeals, such trading by persons who misappropriate material nonpublic information from sources other than the issuer also is prohibited. 3/ Tipping -- the wrongful communication of material, nonpublic information -- by such persons is also prohibited, and the tippees of such persons are also prohibited from trading or tipping. 4/

The prohibitions against insider trading play an extremely important role in the proper functioning of the securities markets. Although they rest on legal concepts of breach of fiduciary duty and misappropriation, they also serve to improve confidence in the fairness and integrity of the securities markets. The incentives for legitimate information gathering, analysis, and dissemination, activities that are essential to the efficient operation of the nation's secur ties markets are diminished when others may wrongfully obtain or use confidential information. Insider trading may undermine investor confidence in the fairness and integrity of the markets, and thereby impair the markets' ability to further capital development and economic growth. The Commission recognizes that market participants will naturally seek an informational edge and that it is desirable for securities prices to reflect value in light of all relevant information. The Commission is not however prepared to condone the exploitation of nformational advantages dishonestly acquired.

2/ The Commission first articulated the prohibition against such insider trading in Cady, Roberts & Co., 40 S.E.C. 907 (1961), stating that corporate insiders have an obligation to abstain from trading in the shares of their corporation unless they have first disclosed to the shareholders any material non-public information known to them. The Cady, Roberts "abstain or disclose" doctrine was subsequently endorsed by the Second Circuit Court of Appeals in SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969).

3/ United States v. Carpenter, 791 F.2d 1024 (2d Cir. 1986), aff'd on securities law counts by an equally divided court, 56 U.S.L.W. 1073 (November 16, 1987); SEC v. Materia, 745 F.2d 197 (2d Cir. 1984), cert. denied, 471 U.S. 1053 (1985); United States v. Newman, 664 F.2d 12 (2d Cir. 1981), aff'd after remand, 722 F.2d 729 (2d Cir.), cert. denied, 464 U.S. 863 (1983). The "misappropriation" theory was previously discussed in the concurring and dissenting opinions in Chiarella v. United States, 445 U.S. 222 (1980).

4/ See Dirks v. SEC, 463 U.S. 646 (1983); SEC v. Texas Gulf Sulphur Co., 401 F.2d at 852.

The Commission's Proposal is a carefully tailored insider trading prohibition that will promote the fairness, efficiency, and integrity of the securities markets, without impeding the important functions of those markets or the free flow of information to the marketplace. While the Commission would not support legislation intended to impose a "parity of information" standard, 5/ the Commission believes it is essential that the law continue to prohibit persons from gaining informational advantages in the securities markets through wrongful conduct. The Commission's Proposal, supplemented by its proposed legislative history, is designed to distinguish such wrongful conduct from legitimate activities, and thereby to protect the integrity of the securities markets.

III. Discussion of the Commission's Proposal

The Commission's Proposal would add a new Section 16A to the Securities Exchange Act and make related conforming amendments to that Act. Section 16A would expressly prohibit conduct commonly referred to as "insider trading," utilizing and clarifying the concepts of breach of duty and misappropriation embodied in the existing law of insider trading. By making use of existing theories, the Commission's Proposal avoids the interpretational uncertainties that a definition based on more novel notions would inevitably entail

Enactment of this legislation would emphasize the significance of proscriptions against insider trading in the regulation of the nation's securities markets and would represent express Congressional approval of the important principles underlying these prohibitions. The Commission's Proposal would set forth within one provision of the securities laws the law governing this conduct. It would provide the investing public and securities industry with additional guidance in ordering their conduct. It also would resolve certain questions that may interfere with effective enforcement of the law.

One of the proposed legislative findings would reflect the intention that proposed Section 16A be the exclusive provision in the federal securities laws under which conduct known as "insider trading" will be addressed Of course, the fact that insider trading cases would be brought under Section 16A would not affect the application of the securities laws to other types of violations that may involve similar conduct. For example, cases

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5/ See generally, Chiarella v. United States, 445 U.S. at 233; Dirks v. SEC, 463 U.S. at 657.

involving manipulation or false or misleading corporate disclosure could still be brought under Section b) or other appropriate provisions of the securities laws, where the elements of such other violations are met, even if trading in securities also occurred. Further, proposed Section 16A would be exclusive only with respect to the federal securities laws. Actions currently cognizable under state law, or other federal statutes such as the mail and wire fraud statutes, would be unaffected.

A. General Prohibition Against Trading -- Subsection 16A(b)(1)

Subsection (b)(1), which contains the basic trading prohibition is targeted against the wrongful trading abuses that have a direct, ignificant effect on our securities markets. This provision would make it clear that a person is prohibited rom purchasing or selling a security while in possession of material nonpublic information relating to the security, if that person knows or recklessly disregards that the information has been "wrongfully obtained," or that such purchase or sale would constitute a "wrongful use" of the information. 6/

The prohibition would clearly reach not only any person who purchases or sells a security for his own account, but also any person who "causes another person's purchase or sale of a security in these circumstances. The concept of "causing" a purchase or sale, which is not included n S. 1380, would, among other things, clarify the application of the prohibition to the situation where one person makes an investment decision for the account of another person -- for example, a broker exercising discretionary nvestment authority for a client, a trustee acting for the account of a beneficiary, or an investment adviser making investment decisions for its clients. In this situation, the person who "caused" the trade to be made would be a primary violator of the law -- i.e.,

6/ One of the proposed legislative findings would reflect the intention to exercise federal jurisdiction in this area to the fullest extent possible, in light of the substantial effect insider trading has on interstate commerce. Thus as under existing law, subsection (h) would provide that the prohibitions against trading and tipping apply to any transaction in connection with which use is made of any means or instrumentalities of interstate commerce, or of the mails, or of the facilities of any national securities exchange, or of the facilities of any automated quotation system maintained for the trading of securities.

the broker, trustee or investment adviser. 7/ The person for whose account the transaction was made would not be a violator of the prohibition, assuming such person did not otherwise participate in the violative conduct. 8/

The critical element of the prohibition would be that the information has been "wrongfully" obtained or used. Two separate categories of such "wrongful" conduct would be set forth, encompassing those activities by which persons improperly obtain use information. The first category, in subsection (b)(1)(A) would cover four specific types of wrongful conduct by which confidential information is obtained or used -- theft, bribery, misrepresentation, or espionage. Thus, for example, if a competitor were to obtain material, nonpublic information about an issuer by industrial espionage, he would be precluded from trading that issuer's securities. 9/ Moreover, a third person who possesses such information and knows or recklessly disregards that it was obtained as a result of another's theft, bribery, misrepresentation or espionage, would also be precluded from trading.

The second category of wrongful conduct, in subsection (b)(1)(B), would address those situations in which information is obtained or used in violation of some express or implied obligation of confidentiality. The wrongful conduct covered by this category would include conversion, misappropriation, and any other breach of a fiduciary duty, a personal or other relationship of trust and confidence, or a contractual or employment relationship. Thus, for example, if material, nonpublic information relating to an issuer is properly disclosed to a person, such as a lawyer or an accountant, with the reasonable expectation that it will be kept confidential, and that person trades the issuer's securities, liability would result under this provision. In addition, if that person tips the information, and the tippee trades, the tippee would be liable if he knew or recklessly disregarded that

7/ For example, where an adviser to an investment company directs trades on behalf of the investment company while in possession of material nonpublic information, the adviser, not the investment company, would be the violator. Cf. H.R. Rep. No. 355, 98th Cong., 1st Sess. 11 (1983).

8/ However, under well-established principles of equity, such person would in most cases be required to disgorge any profits gained or losses avoided from the trading.

9/ Cf. Investors Management Co., Inc., 44 S.E.C. 633, 642 & n. 18 (1971).

the information was obtained as a result of the tipper's breach of duty. Similarly, any subtippees who know or recklessly disregard that the information was wrongfully obtained would be liable for trading.

The broad provisions of subsection (b)(1)(B) would expressly prohibit all conduct that is unlawful under existing principles of liability, including traditional insider trading doctrine and the "misappropriation" theory. By employing the terms "misappropriation" and "conversion," the provision would reach situations in which information is used in a manner inconsistent with a duty o trust and confidence owed to the person providing the information. Under the Commission's Proposal, cases could be premised not only upon the breach of formal fiduciary duties, but also upon the breach of duties that may arise from personal or other relationships, 10/ or the breach of any contractual or employment relationship.

It is anticipated that, as under current law, the application of the prohibition would focus on activities with a significant relationship to the securities markets. The Commission's Proposal is intended to proscribe wrongful conduct in connection with the nation's securities markets, but not otherwise to enforce duties of trust and confidence or to reach conduct that is remote from the securities markets. To the extent this provision which would also provide a basis for private actions, would inappropriately extend to cases in which a substantial nexus to the securities markets is lacking, the Commission would expect to use the broad exemptive authority provided by subsection (f)(1).

Under subsection (b)(1), proof of trading "while in possession of" material nonpublic information would establish a violation where the other elements of the prohibition are met. This provision thus would not require proof that a defendant "used" the nonpublic information for trading or traded "on the basis of" such information The "possession" test would represen ignificant ifference from S. 1380, which would require "use" of the information and create rebuttable presumption that a person who traded "while possession of material, nonpublic information had "used" that information. The Commission supports the "possession" standard. The Commission's experience demonstrates that individuals who have actually traded on the basis of inside information frequently

10/ See United States v. Reed, 601 F. Supp. 685 (S.D.N.Y. 1985).

attempt to invent arguments that they have traded for other reasons. Under a "possession" standard, such post hoc rationalizations would be irrelevant, and could not be used to impede enforcement of the law. Concerns that the "possession" standard would lead to inappropriate iability are unwarranted, in view of the fact that the prohibi ion would require knowing or reckless conduct as a predicate to any violation.

The Commission s Proposal would continue existing law by encompassing within its proscriptions "mate ial, nonpublic" information "relating" to a security. The terms "material" and "nonpublic" are not separately defined in the Commission's Proposal. These terms have been the subjec o much judicial interpretation, and are best left to development on a case-by-case basis. In general, information relating to a security is materi l "if there is a substantial likelihood that a reasonable shareholder would consider important" making an investmen decision or if it would have "signi icantly altered the 'total mix' of information made available to the shareholder. 11/ The Commission's Proposal i intended to reaffirm this standard, and would neither broaden nor narrow the scope of what is material information in the context of an insider trading case

Moreover, the language of the Commission's Proposal -- information "relating" to a security - is consistent with this standard, and would not alter existing law concerning "market" information and "corporate" information. "Corporate inside information" is information from with n a corporation bearing on ts expected earnings or assets. "Market information" concerns events and transactions outside of the corporation that could affect the price of corporate securities. 12/ It is well settled under current law that certain types of information external to a corporation -- for example, information about an impending tender

11/ TSC Industries Inc. v. Northway, 426 U.S. 438, 449 (1976) (footnote omitted). Although Northway involved proxy violations, that test has been applied in insider trading cases as well. See, e.g., United States v. Carpenter, 791 F.2d at 1032 n.9.

12/ See Dirks v. SEC, 463 U.S. at 660 n.15. See generally Brudney, Insiders, Outsiders and Informational Advantages Under the Federal Securities Laws, 93 Harv. L. Rev. 322, 329-330 (1979).

offer -- may be material for purposes of trading in the corporation's securities 13/

Information must also be "nonpublic" for a violation to occur. It is well established that information is nonpublic if it has not been disseminated in a manner making it available to investors generally. 14/ No liability would result under the Commission's Proposal where a person engaging in a face-to-face transaction discloses material information to the other party to the transaction. In such a case, the information would be known to both parties and thus would not be nonpublic for purposes of the particular transaction.

B. Institutional Trading Defense -- Subsection 16A(b)(2)

The Commission's Proposal would provide a defense for institutions, such as multiservice securities firms, in circumstances in which one individual in the firm has material, nonpublic information about a security and another individual in the firm trades in that issuer's securities for the firm's account. The defense would be similar to the defense contained in Commission Rule 14e-3, regulating transactions in securities while in possession of tender offer information. That rule contains an institutional defense from its trading prohibitions when the institution can demonstrate: (1) that the individual or individuals making the trade did not know the information; and (2) that the firm has implemented reasonable procedures, such as Chinese Walls and restricted lists, to ensure that individuals making investment decisions do not violate the trading prohibition in the rule. 15/

13/ S. 380 and the Reconciliation Draft refer to material nonpublic information relating to the security "or the market therefor. The Commission's Proposal does not include this additional language.

14/ See, e.g., Investors Management Co., Inc., 44 S.E.C. 633, 643 (1971).

15/ The substance of the institutional safe harbor in Rule 14e-3 currently applies equally to insider trading cases brought under Section 10(b) of the Securities Exchange Act and Rule 10b-5. See Letter from Chairman John S.R. Shad to Honorable Timothy E. Wirth (June 29, 1983), reprinted in H.R. Rep. No. 355, 98th Cong., 1st Sess. 28 (1983).

(footnote continued)

S. 1380 would afford a defense when the firm could prove that the purchase or sale was not influenced by material, nonpublic information, and that the individual effecting the trade did not know the information. The presence of institutional procedures designed to prevent violations would not be an essential element of the defense. Rather, such procedures are stated to be "relevant evidence" in this regard. This provision apparently would broaden the institutional defense by not requiring the implementation of reasonable procedures as an element of the defense. 16/

The Commission's Proposal adopts more rigorous standard. Under subsection (b)(2) of the Commission's Proposal an institution would have to sustain the burden of proof on two issues. First, it would have to show that "no individual involved in making the investment decisions" on behalf of the institution knew or was influenced by the information This language recognizes that more than one individual may be involved in making a decision to trade for the firm. In such a case, none of those individuals would be permitted to know or be influenced by the information. 17/ Second, the firm would have to show that it had implemented reasonable procedures designed to

(footnote continued)

The question of what procedures are "reasonable" depends on the nature and scope of the person's business. See Securities Exchange Act Release No. 17120, [1980] Fed. Sec. L. Rep. (CCH) ¶ 82,646 at 83,461 (September 4, 1980). Entities which do not regularly come into possession of material, nonpublic information but which do have investment portfolios (e.g., colleges, charitable foundations) would not be expected to maintain "Chinese Walls" or "restricted lists" such as a multiservice securities firm might. In some circumstances, no procedures at all could be reasonable.

16/ See Statement of Charles C. Cox, Commissioner, Securities and Exchange Commission, Before the Subcommittee on Securities of the Senate Banking, Housing and Urban Affairs Committee at 8 (June 19, 1987) ("Cox Testimony").

17/ Only the individuals actually involved in making the investment decision are covered by this language. It would not reach persons with purely supervisory authority with respect to investment decisions, or a compliance officer who, in the proper exercise of the firm's procedures governing exceptions to trading restrictions, authorizes a trade initiated by another person in the firm.

prevent the persons making the type of investment decision at issue from possessing the information. Under this provision, the firm would meet thi element of the defense if it could demonstrate that it had established and maintained reasonable procedures relevant to the particular violation. The availability of the defense would not be affected by evidence that other unrelated aspects of the firm's procedures were flawed.

C. General Prohibition Against Tipping -- Subsection 16A(c)

Subsection (c) contains the general prohibition against tipping material nonpublic information. As the Supreme Court has recognized, tipping, as well as insider trading, must be prohibited in order to protect the securities markets. 18/ The Commission Proposal endorses the important principle that a tipper is liable for the trading of reasonably foreseeable tippees and subtippees Subsection (c) would expressly prohibit a person whose own trading of a security would be prohibited from wrongfully communicating information relating to the security, which the person knows or recklessly disregards is material and nonpublic, to another person who trades or causes trading, if the trading is reasonably foreseeable. In addition, if the tippee communicates the information to subtippees who engage in reasonably foreseeable trading or cause such trading, the original tipper would be iable. 19/

Significantly, this provision would make it clear that "personal benefit" is not a required element of tipper liability. Under existing law, it has been necessary to demonstrate that a tipper anticipated or received a direct or indirect "personal benefit" from the disclosure. 20/ However, the "personal benefit" test, by requiring inquiry into the subjective motives of the tipper through the aggregration of circumstantial evidence, has introduced unnecessary issues and complexities in insider trading cases.

18/ Dirks v. SEC, 463 U.S. at 659.

19/ The Commission's Proposal would not define "communicating." Since a "communication" for purposes of the tipping proscription would continue to include conveying material nonpublic information or its import, by verbal other conduct, the application of this concept would be essentially a factual question requiring a flexible approach best left to case-by-case development.

20/ Dirks v. SEC, 463 U.S. at 662.

Instead of "personal benefit," the Commission's Proposal would focus on the "wrongful" communication of a tipper. In requiring a "wrongful" communication as an element of the violation, the Commission's Proposal would recognize that certain communications made for a proper purpose are not unlawful and should not result in tipping liability even if those communications lead to trading. One example of this is a communication properly made by a corporate official to a market analyst. Market analysts play a crucial role in facilitating the dissemination of information to the marketplace, and thereby promoting healthy and efficient markets. The Commission Proposal would protect routine communications to and from analysts (i.e., communications not in breach of duty), 21/ or communications otherwise made to publicly disseminate information. Indeed, given the importance of their activities, the Commission would consider instituting rulemaking proceedings to ensure that the legitimate functions of analysts will not be inhibited.

Consistent with current law, the Commission's Proposal would impose liability upon a tipper for the trades o tippees who re not themselves liable For example tippee neither knows nor recklessly disregards that formation was wrongfully conveyed, then the tippee would not violate the statute by trading while in possession of the information. The tipper would nevertheless be liable for making a wrongful communication of information that resulted in reasonably foreseeable trading. The Commission's Proposal thus recognizes that a tipper's liability must not depend on whether the tippees broke the law. S. 1380 does not clearly impose liability upon the tipper in such a case. 22/ The Commission's Proposal also would not require that a person who communicates information be liable in order for the recipient of the information to be prohibited from wrongfully trading while in possession of that information. Thus, if a person communicates material nonpublic information under circumstances in which trading by the recipient s not reasonably foreseeable, the recipient would be liable if his trading (or tipping) were wrongful although the person who provided the information is not liable for making the communication.

21/ Although the Commission s Proposal would eliminate the "personal benefit" test, the Commission does not believe it would reverse the result in a case such as Dirks v. SEC, supra. Dirks did not receive information from a person breaching a duty.

22/ See Cox Testimony at 10.

D. Prohibition Against Trading and Tipping While In Possession of Material, Nonpublic Information Relating to a Tender Offer -- Subsection 16A(d)

The Commission's Proposal includes a separate provision addressing insider trading and communication in the context of a tender offer. Subsection (d) would reaffirm existing law in this area by generally codifying the prohibitions contained in Commission Rule 14e-3. The separate treatment of this category of transactions continues to be warranted, in light of the special opportunities for abuse they present, and the substantial impact to the market that can result from them. 23/ The Commission's Proposal would make it unlawful, after substantial steps have been taken to commence a tender offer, to trade while in possession of material, nonpublic information relating to the tender offer, if the trader knows or recklessly disregards that the information has been acquired directly or indirectly from the offering person, the target, or their agents. Communications of material, nonpublic information relating to a tender offer by specified persons, including the offering person, the target, or their agents, also would be prohibited (with the exception of certain good faith communications).

Both S. 1380 and the Reconciliation Draft, by contrast, depart from current law. These proposals include a special provision that would apply in the context of any acquisition or disposition of an issuer or a material portion of its securities or assets -- not only in connection with tender offers. Under these proposals, a person planning such a transaction would be prohibited from communicating material nonpublic information concerning such plans for the purpose of influencing or encouraging trading, except if the communication is made to members of the person's group (within the meaning of Section 13(d)(3) of the Exchange Act) or in the course of a good faith solicitation to join such a group. These provisions would prohibit only the communication, and would not prohibit the recipient of the communication from trading.

The Commission believes Congress should endorse the approach of Rule 14e-3. Security holders who purchase rom or sell to

23/ Unlike the general prohibitions against tipping and trading, subsection (d) would not require a showing that there has been a breach of a duty. Consequently, although in many cases liability might arise under both the general prohibition and subsection (d), in some cases liability could arise only under the latter provision.

persons in possession of information relating to a tender offer are effectively denied the protections of the Williams Act. Moreover, recent experience has shown that trading and the potential for trading while in possession of confidential information relating to a tender offer can result in significant market disruption and abusive practices. Such consequences have a detrimental impact on shareholder protection, tender offer practices, and the securities markets. Accordingly, the Commission continues to believe that the communication, and trading while in possession of such information should be prohibited by the federal securities laws. The Commission does not believe, however, that similar prohibitions are warranted when transactions other than tender offers are involved. In most cases that will arise involving these other transactions, persons obtaining material nonpublic information will owe duties of confidentiality to a party involved in the transaction, and their trading or tipping would give rise to liability under the general prohibitions of Section 16A. In addition, the broad application of the prohibitions of S. 1380 would extend to transactions such as block purchases of securities, which could create uncertainties as to the status of ordinary market transactions and expose market participants to potential liability in the absence of impropriety.

E. Derivative Liability -- Subsection 16A(e)

Subsection   would address the issue of derivative liability for controlling persons and employers of other persons who violate Section 16A. The subsection would state that, except as provided in Section 20(a) of the Exchange Act, 24/ no person is liable solely by reason of employing or controlling another person who violates the section, "if such controlling person or employer did not participate in, profit from, or directly or indirectly induce the acts constituting the violation."

24/ Section 20(a) provides that "[e]very person who, directly or indirectly, controls any person liable under any provision of this title or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action." "Controlling person" includes not only employers, but any person with power to influence or control the direction of the management, policies, or activities of another person.

The Commission's Proposal differs from S. 1380 on this issue. S. 1380 provides that an employer or controlling person would be derivatively liable only if it has participated in, or directly or indirectly induced the violation. However, S. 1380, as the exclusive prohibition of insider trading, could be interpreted to exclude controlling person liability under Section 20(a). Therefore, the Commission's Proposal expressly provides that Section 20(a) will continue to be applicable to insider trading cases

The imposition of derivative liability on employers and controlling persons under Section 20(a) provides an incentive for employers and controlling persons to take reasonable steps to prevent violations by persons acting on their behalf and within their direction or control. It is also appropriate that controlling persons and employers who participate in or profit from a violation be subject to liability. The Commission's Proposal would not, however, expose an employer or controlling person to potential litigation or liability in the event of insider trading violations by errant employees or agents which cannot reasonably be prevented and do not operate to benefit them. Thus it would rule out causes of action based on respondeat superior in insider trading cases. 25/

F. Exemptions -- Subsection 16A(f)

Subsection (f)(1) would give the Commission authority to exempt, by rule or order, any person, security, or transaction (or class of person, security, or transaction), from the provisions of the legislation, where such exemption is not inconsistent with the purposes of the section. As noted above, the Commission's experience after enactment of this legislation may indicate that it is necessary to consider exemptions in certain areas -- for example, for certain communications to and by market analysts -- and the proposal would give the Commission sufficient flexibility to address such issues as they arise.

The Commission's Proposal would not specifically grant the Commission authority to make general regulations under Section 16A. Such authority is unnecessary in view of the Commission's existing authority under the Exchange Act. For example, Section 23(a) of the Act provides broad general rulemaking authority, and Section 3(b) of the Act provides authority to define terms.

25/ This provision does not address the general applicability of the respondeat superior theory under the federal securities laws, and does not affect the availability of any other theories of secondary liability, such as aiding and abetting or the failure to supervise, in appropriate circumstances.

Subsection (f)(2) provides that the prohibitions of Section 16A will not apply to agents acting at the direction of, and solely for the account of, their principals, when the transaction or communications would be lawful under the Section if done directly by the principal while in possession of the information. It is evident in today's complex markets that the execution of investment plans requires the assistance of others acting on one's behalf. Thus, for example, a tender offeror's agent who possesses material nonpublic information with respect to the planned tender offer would not violate Section 16A by effecting, or authorizing subagents to effect, trades in the offeree's stock for the account of the principal. However, the exemption applies only when the trades would be lawful for a principal who actually possessed the nonpublic information. Further, this exemption would not apply to an agent acting on behalf of the principal when the agent has otherwise wrongfully obtained the information.

G. Private Rights of Action -- Subsection 16A(g)

The Commission's Proposal would provide express private rights of action for two classes of persons persons who have traded contemporaneously with the violators and other persons who are injured by a violation in connection with thei securities trading. The victims of insider trading may suffer substantial economic losses, and should be afforded a direct and effective means of redress for their injuries. Private rights of action have traditionally served as an important supplement to the Commission's enforcement of the federal securities laws.

First, the Commission's Proposal would provide contemporaneous traders a right of recovery against inside traders or tippers. It thus would reverse cases that have precluded such recovery in misappropriation cases, 26/ and even in traditional insider trading cases where the plaintiffs neither dealt with the defendants nor were influenced in their trading decision by the defendants' trading. 27/ However, the liability of a violator to contemporaneous purchasers or sellers would be limited to the profit gained or the loss avoided as a result of the violation. Damages imposed against a defendant in such a case would be diminished by the amount that the defendant has paid as disgorgement in a Commission injunctive action relating to the same violation.

26/ Moss v. Morgan Stanley, Inc., 719 F.2d 5 (2d Cir. 1983), cert. denied, 465 U.S. 1025 (1984).

27/ Fridrich v. Bradford, 542 F.2d 307 (6th Cir. 1976), cert. denied, 429 U.S. 1053 (1977).

Second, the Commission's Proposal affirms existing cases that provide standing to any other persons, such as tender offerors, injured by insider trading in connection with thei securities transactions. Unlike contemporaneous traders, such plaintiffs would be required to prove that their damages were caused by the violation. However, their damages would not be limited to the amount of profit gained or loss avoided by the defendants. Further, other issues associated with this type of case, such as the type of injury covered and the measure of damages would be addressed on a case-by-case basis. S. 380 does not expressly provide a private right of action to any plaintiff other than a contemporaneous trader and would likely be interpreted to preclude such an action. 28/

B. Other Amendments

1. Amendments to Subsection 21(d)(2) of the Securities Exchange Act

Section (d)(2) of the Exchange Act added by the Insider Trading Sanctions Act of 1984, provides that the Commission may bring an action to seek civil penalties against any person who illegally trades while in possession of material nonpublic information or tips such insider information. Section 3 of the Commission's Proposal would amend Section 21(d)(2) to conform its scope to the scope of proposed Section 16A. The Commission's Proposal would make clear that civil penalties are available for any primary violation of Section 16A -- whether predicated on purchasing or selling securities while in possession of material nonpublic information, causing a purchase or sale while in possession of such information, or communicating such information. 29/ The proposal would not, however, affect the provisions of Section 21(d)(2)(B) that state that civil penalties are not available against persons who are derivatively liable for violations as control persons, employers, or otherwise as aiders and abettors.

28/ See Cox Testimony at 13.

29/ The proposal also would delete language in Sections 21(d)(2)(A) and (B) that categorizes tipping as an aiding and abetting violation for purposes of the penalty provision. It thus would conform the analysis of tipping under the provisions to that utilized to determine the underlying violations: tipping would be treated as a primary violation.

2. Amendments to Subsection 20(d) of the Securities Exchange Act

Section 20(d) of the Exchange Act currently provides that when the communication of confidential information, or the purchase or sale of a security while in possession of confidential information would be illegal, such conduct also is illegal with respect to "a put, call, straddle, option, or privilege with respect to uch security or with respect to a group or index of securities including such security." Section 4 of the Commission's Proposal would amend Section 20(d) to clarify that such conduct also is illegal with respect to debt securities (i.e., any note, bond, debenture, evidence of indebtedness or similar debt security) of the issuer of a security if the material nonpublic information would be material with respect to such debt securities, and with respect to securities convertible into or exchangeable for the securities of the issuer In addition, consistent with the purpose of providing the exclusive standards for insider trading in Section 16A, Section 20(d) would be recodified by the legislation as Section 16A(i) of the Exchange Act.

IV. Conclusion

The Commission appreciates the opportunity to testify on its proposal for legislation to define insider trading. The Commission believes that its proposal would effectively address the prohibition of insider trading and promote the integrity of the securities markets. The Commission would be pleased to provide any furthe assistance to the Subcommittee in its consideration of this important issue.

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF
THE CHAIRMAN

November 18, 1987

The Honorable Donald W. Riegle, Chairman
Securities Subcommittee of the Committee on
Banking, Housing, and Urban Affairs
United States Senate
Washington, D.C. 2051

The Honorable Alfonse M. D'Amato
Securities Subcommittee of the Committee on
Banking, Housing, and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Chairman Riegle and Senator D'Amato:

By letter dated August 11, 1987, you requested that the Commission assist the Subcommittee in its efforts to develop a consensus proposal for legislation to define insider trading. That letter followed the Commission's August 7 testimony before the ubcommittee at which Commissioner Cox explained the insider trading bill which the Commission proposed on August 3, and outlined the differences between the Commission's proposal and S. 1380, legislation drafted by the Ad Hoc Legislative Committee chaired by Harvey L. Pitt.

In response to your request, members of the Commission's staff met with representatives of the Ad Hoc Committee to discuss a potential compromise. Following those meetings, and as a result of further consideration of the definition, the Commission, acting by a majority, determined that it could support legislation that differs in certain respects from the Commission's original proposal and includes certain provisions adopted from S. 1380. The enclosed bill represents a proposal for compromise legislation that would be acceptable to a majority of the Commission, provided that certain interpretive positions described below are clearly set forth in the legislative history accompanying the bill. */ With the exception of one substantive

*/ Transmittal of this legislation was approved, following deliberation, pursuant to formal Commission action. Commissioner Grundfest's position on the proposed legislation is contingent on the contents of the as yet uncompleted legislative history that the Commission will propose to accompany the bill. Commissioner Fleischman did not join in accepting the proposed legislation or the proposals for legislative history.

area in which it was not possible to reach agreement, and certain differences as to language believed to be technical in nature, it is my understanding that this bill would also be acceptable to the Ad Hoc Committee.

The compromise proposal retains many important aspects of the Commission's original proposal. Among other things, it retains a "wrongfulness" approach in its general trading prohibition that reaches both the theft of information and the use of information in breach of a duty; it prohibits trading while "in possession of" material, nonpublic information, rather than requiring the "use" of such information for trading; it includes a tipping prohibition that expressly imposes liability based on reasonably foreseeable trading by direct and indirect tippees; and it creates broad private rights of action for contemporaneous traders and other persons injured in their securities transactions by insider trading violations.

The compromise bill also includes certain provisions adapted from S. 1380 that would be acceptable to a majority of the Commission, provided the legislative history resolves certain interpretive issues in the manner described below. First, like S. 1380, and unlike the Commission's August 3 proposal, the compromise bill includes the terms "misappropriation" and "conversion" in the basic prohibitions against wrongful trading and tipping. Similarly, the trading prohibition section in the compromise bill does not specifically enumerate sources to whom a breach of duty must be owed for liability to arise. Finally, the compromise bill does not include express exemptions for communications made by or to analysts, or communications made to disseminate information publicly, as did the Commission's proposal. Instead of the analyst exemption, the compromise embodies a "wrongfulness" concept in the general tipping prohibition.

The one substantive area in which it was not possible to reach agreement with the Ad Hoc Committee concerns the issue of communications relating to a person's own plans to acquire an issuer. The enclosed bill, which would continue existing law in this area, generally codifies Commission Rule 14e-3 by making it unlawful, after substantial steps have been taken to commence a tender offer, to trade while in possession of material, nonpublic information relating to the tender offer, if the trader knows or recklessly disregards that the information has been acquired directly or indirectly from the offering person, the target, or their agents. Tipping by specified persons, including the offering person, the target, or their agents, also would be prohibited (with the exception of certain good faith communications). S. 1380, by contrast, would prohibit a person planning to acquire or dispose of an issuer or a material block of its securities or assets from communicating its plans, if the purpose of the communication is to influence or encourage

trading; exceptions are made for communications to members of the person's group (within the meaning of Section 13(d)(3) of the Exchange Act) or in the course of a good faith solicitation to join such a group. A majority of the Commission believes it preferable to retain the approach of Rule 14e-3. The demonstrated potential for insider trading abuses in the tender offer area warrants maintaining the substance of the protections afforded by current law. The Commission does not believe, however, that such provisions, which go beyond the "wrongfulness" rationale as defined in the proposal's principal prohibitions, are warranted when transactions other than tender offers are involved.

As noted above, the Commission's support for the enclosed compromise proposal is contingent on the proper resolution of several important interpretive issues in the bill legislative history. In particular, if the Committee determines to report this legislation to the full Senate, the Committee report should clarify the following issues:

- The Commission's authority to exclude particular sources -- The compromise bill does not include the enumerated sources provision contained in the Commission's proposal. However, the legislative history should state that it is not the intent of the legislation to reach conduct lacking a significant relationship to the securities markets. Moreover, the legislative history should specifically state that the Commission could use the broad exemptive authority provided in the bill to exempt persons whose information is obtained from sources whose nexus to the securities markets is remote or insubstantial. Hence, the Commission could, by rule, provide that misappropriation from particular sources with no regular nexus to the securities markets would not violate the statute.

- The import of "misappropriation" and "conversion" -- The compromise bill includes these terms. The legislative history should make clear, however, that, as under existing case law, "misappropriation" and "conversion" refer to possession or use of information in breach of a pre-existing duty of confidentiality or non-use arising from the expectations of the parties thereto, or from law. The proposed Section 16A(b) per se does not create such duties, nor would Section 29 of the Securities Exchange Act invalidate otherwise lawful agreements to waive any such pre-existing duties.

- The scope of the bill's exclusivity -- The compromise bill contains a legislative finding on exclusivity. The legislative history should clarify two important points. First, the statute is only exclusive with

respect to the federal securities laws; actions brought under state law, or the federal mail and wire fraud or other statutes, are unaffected. Second, the exclusivity provision would not affect the Commission's ability to proceed under Section 10(b) and other provisions of the federal securities laws in cases involving manipulation, false or misleading corporate disclosure, or other violative conduct, where the elements of such other violations are met, even though insider trading also exists.

- The application of the prohibitions to market information -- The compromise bill governs certain communications, and trading while in possession of, material nonpublic information "relating" to a security. The legislative history should state that the bill is intended to reaffirm existing law concerning "market" information and "corporate" information, and regarding what constitutes "material nonpublic information," including the Supreme Court's disavowal in Chiarella v. United States, 445 U.S. 222 (1980), that a "parity of information" theory is intended.

- The application of the bill to communications leading to public disclosure -- The compromise bill does not include the Commission's proposed exemptions for communications made by or to analysts, or made to disclose information publicly. However, it does include the concept of "wrongfulness" in the general proscriptions against tipping. The legislative history should emphasize the crucial role played by market analysts in the dissemination of information to the marketplace and in the promotion of healthy and efficient markets. It should make clear that the inclusion of a wrongfulness element is intended to assure that routine communications (i.e., not in breach of duty) to and from analysts are not prohibited, and communications properly made to disseminate information publicly also are not prohibited. The legislative history should further indicate that, in view of the importance of such activities, further clarification of, or exemptive relief from, the provisions of the bill may be appropriate and should be carefully considered. Thus, it should state that the Committee intends that the Commission consider rulemaking proceedings addressing these important and difficult issues.

- The scope of derivative liability -- The compromise proposal preserves controlling person liability under Section 20(a) of the Securities Exchange Act in insider trading cases, but rules out respondeat

superior liability except when the employer has participated in, profited from, or induced the violation. The legislative history should state that Congress expresses no view on whether the respondeat superior theory is applicable to other securities law violations. It should also make clear that this provision does not affect the Commission's ability to bring cases against employers or controlling persons under such theories as aiding and abetting or the failure to supervise, where appropriate.

o <u>The application of the bill to private transactions</u> -- The legislative history should state that no liability would result under the bill where a person engaging in a face-to-face transaction disclosed material nonpublic information to the person on the other side of the trade; in such a situation, the information would be known to both parties and thus would not be nonpublic for purposes of the particular transaction.

The Commission s staff has been requested to prepare specific suggested report language addressing these issues, which will be transmitted to you as soon as possible.

I look forward to working further with you and the Subcommittee on this important matter. I am also sending a copy of this letter to Mr Pitt. understand that he is sending you a letter reflecting his committee's views of the compromise legislation.

Sincerely,

David S. Ruder

David S. Ruder
Chairman

Enclosure

cc: Office of Management and Budget */
Harvey L. Pitt, Esq.

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*/ The enclosed legislative proposal represents the views of a majority of the Commission, and does not necessarily represent the views of the President. By copy of this letter, the enclosed proposal is also being transmitted to the Office of Management and Budget.

SECURITIES AND EXCHANGE COMMISSION
PROPOSED INSIDER TRADING BILL

November 18, 1987

A BILL

To amend the Securities Exchange Act of 1934 to prohibit certain securities trading, or communications related thereto, by those who possess material, nonpublic information.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SEC. 1. SHORT TITLE.

This Act may be cited as "The Insider Trading Proscriptions Act of 1987".

SEC. 2. INSIDER TRADING PROSCRIPTIONS.

Chapter 78 of Title 15, United States Code, is amended, by adding after section 78p the following:

"§16A. PROSCRIPTIONS AGAINST WRONGFUL SECURITIES TRADING WHILE IN POSSESSION OF, OR WRONGFUL COMMUNICATION OF, MATERIAL, NONPUBLIC INFORMATION.

"(a) (1) The fairness, efficiency and integrity of the Nation's securities markets are impaired when corporate insiders or other persons who obtain material, nonpublic information relating to an issuer of securities, or a particular security or a group of securities wrongfully trade, or wrongfully cause the trading of, securities while in possession of such information, or wrongfully communicate such information to others who trade such securities.

"(2) The wrongful trading of securities is effected, to a substantial extent, by the use of the means or instrumentalities of interstate commerce, of the mails, of the facilities of national securities exchanges, or of the facilities of automated quotation systems maintained for the trading of securities. Even when the wrongful trading in securities while in possession of material, nonpublic information relating thereto, and the wrongful communication of such information, are primarily effected through intrastate devices, these activities nonetheless have such a direct effect on interstate and foreign commerce that the Congress intends, by this Act, to exercise its jurisdiction over such activities to the fullest extent possible.

"(3) Effective prohibitions against wrongful securities trading and communications by persons who possess material, nonpublic information, are necessary to preserve the integrity of the Nation's securities markets and should not impede their ability to serve important domestic and international economic functions, including capital formation.

"(4) There is an important public interest in the prompt flow of information to the securities markets.

"(5) It is appropriate to, and this section does, establish exclusive statutory prohibitions that clarify the conduct that constitutes the wrongful trading of securities while in possession of material, nonpublic information, and the wrongful communication of such information, under the federal securities laws, thereby reducing uncertainties in the state of

the law without otherwise affecting existing statutory prohibitions against manipulative, deceptive or fraudulent conduct.

"(b) (1) It shall be unlawful for any person, directly or indirectly, to purchase, sell, or cause the purchase or sale of, any security, while in possession of material, nonpublic information relating thereto, if such person knows or recklessly disregards that such information has been obtained wrongfully, or that such purchase or sale would constitute a wrongful use of such information. For the purposes of this subsection, such trading while in possession of material, nonpublic information is wrongful only if such information has been obtained by, or its use would constitute, directly or indirectly, (A) theft, bribery, misrepresentation, espionage (through electronic or other means) or (B) conversion, misappropriation, or any other breach of a fiduciary duty, breach of any personal or other relationship of trust and confidence, or breach of any contractual or employment relationship.

"(2) The prohibitions of subsections (b)(1) and (d)(1) of this section shall not apply in the case of a person, other than a natural person, who sustains the burden of proving that:

"(A) no individual involved in making the investment decision on behalf of such person to purchase or sell the security, or to cause the purchase or sale of the security by or on behalf of others, knew, or was influenced by, the material nonpublic information; and

"(B) such person had implemented one or a combination of policies and procedures, reasonable under the circumstances, taking into consideration, among other things, the nature of the person's business, designed to prevent the individuals making the investment decision involved from possessing the material nonpublic information.

"(c) It shall be unlawful for any person whose own purchase or sale of a security would violate paragraph (b) of this section, directly or indirectly, wrongfully to communicate information relating thereto that such person knows or recklessly disregards is material and nonpublic to any other person who, while in possession of such information, directly or indirectly, purchases, sells, or causes the purchase or sale of, any security that is the subject of the communication, or who communicates the information to another person who makes or causes such a purchase or sale while in possession of such information, if such purchase or sale is reasonably foreseeable. For purposes of this subsection, information is wrongfully communicated only if the person making the communication knows or recklessly disregards that the information communicated has been obtained by, or its communication would constitute, directly or indirectly, (A) theft, bribery, misrepresentation, espionage (through electronic or other means) or (B) conversion, misappropriation, or any other breach of a fiduciary duty, breach of any personal or other relationship of trust and confidence, or breach of any contractual or employment relationship.

"(d) (1) If any person has taken a substantial step or steps to commence, or has commenced, a tender offer (the "offering person"), it shall be unlawful for any other person who is in possession of material nonpublic information relating to such tender offer, which information such other person knows or recklessly disregards has been acquired directly or indirectly from (i) the offering person, (ii) the issuer of the securities sought or to be sought by such tender offer, or (iii) any officer, director, partner or employee or any other person acting on behalf of the offering person or such issuer, to purchase or sell or cause to be purchased or sold any security of such issuer, except for sales to the offering person.

"(2) (A) It shall be unlawful for any person described in paragraph (2)(B) of this subsection (d) to communicate, directly or indirectly, material nonpublic information relating to a tender offer to any other person under circumstances in which it is reasonably foreseeable that such communication is likely to result in a violation of this Section, except that this paragraph shall not apply to a communication made in good faith:

"(i) to the officers, directors, partners or employees of the offering person, to its advisors or to other persons, involved in the planning, financing, preparation or execution of such tender offer;

"(ii) to the issuer whose securities are sought or to be sought by such tender offer, to its officers, directors, partners, employees or advisors or to other person, involved in the planning, financing, preparation or execution of the activities of the issuer with respect to such tender offer; or

"(iii) to any person pursuant to a requirement of any statute or rule or regulation promulgated thereunder.

"(B) The persons referred to in paragraph (2)(A) of this subsection (d) are:

"(I) the offering person or its officers, directors, partners, employees or advisors;

"(II) the issuer of the securities sought or to be sought by such tender offer or its officers, directors, partners, employees or advisors;

"(iii) anyone acting on behalf of the persons described in paragraph (2)(B)(I) or (2)(B)(II) of this subsection; and

"(iv) any person in possession of information relating to a tender offer which information such person knows or recklessly disregards is material and nonpublic and has been acquired directly or indirectly from any person described in this paragraph (2)(B).

"(e) Except as provided in Section 20(a) of this title, no person shall be liable under this section solely by reason of the fact that such person controls or employs a person who has violated this section, if such controlling person or employer did not participate in, profit from, or directly or indirectly induce the acts constituting the violation of this section.

"(f) (1) The Commission may, by rule, or by order, exempt any person, security or transaction, or any class thereof, from any or all of the provisions of this section, upon such terms and conditions as it deems necessary or appropriate, if the Commission determines, by reason of the nature of such person, security, transaction, or class thereof, or otherwise, that such action is not inconsistent with the purposes of this section.

"(2) The prohibitions of this section shall not apply to any person who acts at the specific direction of, and solely for the account of, a person whose own securities trading, or communications of material, nonpublic information, would be lawful under this section.

"(g) (1)(A) Any person who violates subsection (b) or (d)(1) of this section shall be liable in an action in any court of competent jurisdiction to any person who, contemporaneously with the purchase or sale of securities that forms the basis of such violation, has purchased (where such violation is based on a sale of securities) or sold (where such violation is based on a purchase of securities) securities of the same class.

"(B) Any person (other than a person entitled to recovery solely under paragraph (1) of this subsection) injured by a violation of this section in connection with such person's purchase or sale of securities may bring an action in any court of competent jurisdiction to seek recovery of any damages caused by reason of such violation, or for appropriate equitable relief, or both.

"(2) No person shall be liable in damages in any private action under subsection (g)(1)(A) of this section for an amount in excess of such person's actual profit obtained or loss avoided. Any damages imposed against any person under subsection (g)(1)(A) of this section shall be diminished by the amounts, if any, that such person may be required to disgorge, pursuant to a court order obtained at the instance of the Commission, in a proceeding brought under section 21(d) of this title relating to the same transaction or transactions.

"(3) Any person who violates subsection (c) or (d)(2) of this section shall be liable, jointly and severally, with and to the same extent as any persons who obtained profits or avoided losses as a result of such violations of subsection (c) or (d)(2).

"(4) The period of limitations for the commencement of any private action under this section shall be the same as that provided in section 21(d)(2)(D) of this title (the Insider Trading Sanctions Act).

"(h) The prohibitions of this section shall apply to any transaction in securities in connection with which use is made of any means or instrumentalities of interstate commerce, or of the mails, or of any facilities of any national securities exchange, or of any facilities of any automated quotation system maintained for the trading of securities."

SEC. 3. AMENDMENTS TO THE INSIDER TRADING SANCTIONS ACT.

Chapter 78 of title 15, United States Code, is amended by deleting the words "in a manner other than by communicating material nonpublic information" from the first sentence of section 78u(d)(2)(B) and by striking the first two sentences of section 78u(d)(2)(A) and inserting in lieu thereof the following:

> Whenever it shall appear to the Commission that any person has violated section 16A of this title or the rules or regulations thereunder in a transaction (i) on or through the facilities of a national securities exchange or from or through a broker or dealer, and (ii) which is not part of a public offering by an issuer of securities other than standardized options, the Commission may bring an action in a United States district court to seek, and the court shall have jurisdiction to impose, a civil penalty to be paid by such person. The amount of such penalty shall be determined by the court in light of the facts and circumstances, but shall not exceed three times the profit gained or loss avoided as a result of the purchases or sales resulting from such violation, and shall be payable into the Treasury of the United States.

SEC. 4. AMENDMENT TO SECTION 20(d) OF THE SECURITIES EXCHANGE ACT.

(a) Section 78t(d) of chapter 78 of title 15, United States Code, is amended, by striking the words

> Whenever communicating, or purchasing or selling a security while in possession of, material, nonpublic information would violate, or result in liability to any purchaser or seller of the security under any provision of this title, or any rule or regulation thereunder, such conduct in connection with a purchase or sale of a

and inserting in lieu thereof the following:

> Whenever communicating, or purchasing or selling a security while in possession of, or causing the purchase or sale of a security while in possession of, material, nonpublic information would violate this section, such conduct in connection with a purchase or sale of a note, bond, debenture, evidence of indebtedness or similar debt security of the issuer of such security (when such information would be material with respect to such note, bond, debenture or similar security), a security convertible into or exchangeable for such security, or a

(b) The Securities Exchange Act of 1934 is amended by redesignating section 20(d) as section 16A(i).

SEC. 5. EFFECTIVE DATE.

This Act shall take effect immediately.

Senator RIEGLE. Chairman Ruder, let me just say, in response to your last point, that we hear you loud and clear and I think your argument is a very compelling one. Certainly everything we've seen would indicate that we do not want to be short-handed in this area at a time of extraordinary requirements—reconstructing the events of October 19 and 20 and the recommendations that you have to be in a position to make with respect to the tremendous changes now taking place such as, internationalization, and the growth in volume and complexity that we've seen in the securities markets.

I will prepare a letter today from the subcommittee and members of the full committee to the appropriate parties indicating some sense of urgency about the critical needs of the SEC at this time.

I think investor confidence and psychology and the safety and soundness of the markets are very much related to our ability to do this job properly. So I will draft such a letter and I hope my colleagues will join me in signing it. It's not as if you're asking for money that you're not earning. You're earning the money fully and, as a matter of fact, you're returning extra money to the Treasury.

So it's obvious to me, given the fact that you're self-financing as well as the fact that you face these extraordinary needs, that we ought to be helping you. And I intend to do all I can, hopefully with my colleagues, to do exactly that.

Mr. RUDER. Thank you very much.

Senator RIEGLE. Before I begin my questioning, Senator Hecht, you've come in. Do you have a comment at this point?

Senator HECHT. No. Thank you very much.

Senator RIEGLE. In today's newspapers, Chairman Ruder, it's reported that the Government's presentencing memorandum said that the former arbitrageur, Ivan Boesky, has given investigators "a window on the rampant criminal conduct" that has "permeated the securities industry" and that he has "revealed that criminal conduct is at the heart of a substantial amount of market activity by established securities professionals."

I thought that was a very strong statement to make.

First of all, I want to know if you agree with this Government assessment insofar as your own understanding of the situation?

Mr. RUDER. I agree that there is and always will be a substantial amount of insider trading activity. It is a kind of activity which usually involves relatively fixed dollar amounts, particularly in the tender offer area but also in other areas. It is the ability to measure profit which makes insider trading seem like such desirable conduct, and I believe that it is important to have whatever weapons necessary to attack such conduct. And, although the Commission does not have criminal powers, it has criminal reference powers, and we support criminalization of that activity.

Senator RIEGLE. I'm going to ask that this article in today's Wall Street Journal be made a part of the record at this point.

[The article referred to follows:]

THE WALL STREET JOURNAL TUESDAY, DECEMBER 15, 1987 5

Boesky Disclosed 'Rampant' Criminality In Securities Industry, U.S. Memo Says

By JAMES B. STEWART
Staff Reporter of THE WALL STREET JOURNAL

NEW YORK—Former arbitrager Ivan F. Boesky has given investigators a "window on the rampant criminal conduct" that has "permeated the securities industry," the government said in a pre-sentencing memorandum describing Mr. Boesky's cooperation.

The government said "dozens" of individuals are currently under investigation as a result of Mr. Boesky's disclosures. The comments are the government's most explicit so far about the progress of its massive investigation of wrongdoing on Wall Street and the value of Mr. Boesky's cooperation.

Mr. Boesky "revealed that criminal conduct is at the heart of a substantial amount of market activity by established securities industry professionals," the government said.

Mr. Boesky, who pleaded guilty to one felony for his role in Wall Street's insider trading scandal, is scheduled to be sentenced this Friday. He faces a maximum prison term of five years and a maximum fine of $250,000.

According to the government, the crimes disclosed by Mr. Boesky, in addition to insider trading, include manipulation of stock prices, unlawful takeover activity, undercapitalization of broker-dealers, the filing of false books and records, failure to disclose participation in a group controlling more than 5% of the stock in a company, and so-called parking of stock as an accommodation to others. As for parking, the government said it is an illegal practice that appears to be "deeply rooted in the brokerage industry." Parking occurs when one investor buys a stock for another investor who doesn't want to be identified as the owner.

The government's memorandum released by the court was heavily censored so as not to disclose the names of any people implicated by Mr. Boesky that haven't already been identified by the government.

Among those known to be under investigation as a result of Mr. Boesky's disclosures are Michael Milken, head of the "junk" bond operations of Drexel Burnham Lambert Inc.; New York investor Carl Icahn; and John Mulheren, an arbitrager and head of Jamie Securities Inc. None has been charged with any wrongdoing and all three have asserted their innocence.

Mr. Boesky's cooperation has led to guilty pleas by Martin A. Siegel, the former Kidder, Peabody & Co. takeover specialist, and Boyd L. Jefferies, former chairman of Jefferies & Co. His cooperation also has led to numerous criminal charges against individuals involved in the Guinness PLC takeover scandal in Britain.

The government emphasized that it knew only about an insider trading scheme involving Mr. Boesky and former investment banker Dennis B. Levine when Mr. Boesky surrendered a year ago and agreed to cooperate. The government said that Mr. Boesky's cooperation has been "unprecedented" and that not since the passage of the securities laws in the 1930s has the government "learned so much at one time about securities law violations."

In its memo, the government didn't recommend any sentence, but asked U.S. District Judge Morris Lasker, who is scheduled to sentence Mr. Boesky on Friday, to weigh Mr. Boesky's "serious and widespread criminal conduct" against his "outstanding' cooperation."

The government memo was released by Judge Lasker in response to motions filed by Newsday, a Long Island, N.Y., newspaper, and American Lawyer magazine. In a letter to the judge opposing American Lawyer's motion for release of the entire memo, the government wrote that releasing censored portions of the memo would provide "Drexel Burnham with premature access to closely held details of the ongoing criminal investigation," apparently confirming that Drexel is under investigation. John Carroll, the assistant U.S. attorney handling the matter, said that "the letter speaks for itself."

Senator RIEGLE. I'm just wondering if you can shed any light on what is described here as "rampant criminal activity." That's an awfully strong phrase.

Mr. RUDER. Well, Chairman Riegle, as you know, I am not at liberty to comment on any ongoing investigations, and we still have ongoing investigations stemming from the Ivan Boesky matter. So what I say is and should be considered as apart from anything to do with those investigations.

HUMAN GREED

But as I indicated, insider trading is a natural outcome of human greed, and it is something which is very hard to detect. Usually our enforcement cases in the insider trading area involve circumstantial evidence. It is the rare case in which we have a confession or an indication by others that they have participated in or observed insider trading.

The use of the word "rampant" is one that may be a little strong. I believe that most participants in the securities markets essentially are honest. However, it is those few people who disregard the law whom I think must be punished, must be forced to disgorge their profits, so that we can preserve the integrity of our securities markets.

Senator RIEGLE. Let me ask you this without getting into specific cases—and we've been very careful not to do that here. As a matter of fact, when the prosecutor from New York was present and seemed to be willing to be forthcoming to some of the questions, I chose not to pursue those matters because I didn't want there to be any question about us stepping over a line of confidentiality in pending investigations.

But can you give us some sense about timing here? These investigations have been going on a long time and I know they are complex.

I'm wondering if you can give us any sense as to when we might see that happening?

Mr. RUDER. Could you give me just one moment to confer with my staff as to the amount of information that I may communicate to you?

Senator RIEGLE. Certainly.

[Witness conferring with Commission staff.]

Mr. RUDER. Thank you, sir. It's always pleasing to me when my thoughts are confirmed by my staff. [Laughter.]

What I had intended to say and do say is that we are devoting a substantial amount of our Commission resources to complex investigative actions stemming from communications that we've had from persons who have admitted to their criminal acts.

INVESTIGATIONS UNDERWAY

These investigations are underway, and they are being vigorously undertaken, and I can assure you that at such time as we have completed the investigative process we will be bringing the appropriate enforcement actions and cooperating with the U.S. Attorney's Office in bringing criminal charges.

The delay, if any, is due not to our unwillingness or lack of desire, but to the exceedingly complicated nature of some of these cases.

Senator RIEGLE. I have two related questions. Does that mean that we can expect some major cases to come forward here at some point?

Mr. RUDER. Yes, sir.

Senator RIEGLE. Are we likely talking in terms of weeks or are we talking in terms of months?

Mr. RUDER. Probably in terms of months rather than weeks. At least as I understand it, we are not imminently in the position of bringing these cases.

Senator RIEGLE. I take it from what you say that there are a number of major cases that you are pursuing, that you are developing, that you have reason to think will result in criminal prosecutions and actions; that because they are so complex putting these cases together in a form in which they can be prosecuted takes more time; that you're moving ahead as fast as you can; and that once that work is completed, we will be seeing a number of cases brought forward that would be by any definition called major cases. Is that a fair summary or not?

Mr. RUDER. I must qualify my response to the question and I must tell you that one of our functions as a Commission is not only to investigate and enforce where appropriate cases in which wrongdoing exists, but also, as a Commission, to evaluate staff recommendations regarding cases of this kind.

Our staff, in due course, will present to the Commission sitting in closed meetings extensive factual and legal analysis of the various situations, and one of the responsibilities that we have as a Commission is to evaluate these matters and decide whether or not it is appropriate to bring these cases.

Now I have every reason to believe from information given to me from the staff that our decisions will be positive in this regard, but I can't at this time give you firm assurances that we will be bringing large numbers or few cases.

I can tell you that these are extremely important ones and extremely complex cases, but I do not want on the other hand to seem to predict anything about the nature of these cases nor the nature of the parties whom we will be dealing with.

Senator RIEGLE. Well, let me pose one other question here. When your predecessor appeared before us and was asked on this matter—I don't have the committee transcript immediately in front of me, although I could get it, but in essence, this is what he said—that there were major cases under development, that shoes would be dropping—I think that was the phrase used. The sense of the timing was that we could expect concrete action this year and many of us had that expectation based on those statements.

We have not seen that happen and I think we need to have some sense as to the implications of that. If the implication is, as the story in the paper today indicates, that these investigations and revelations have led to a much broader number of circumstances and that in fact the situation has widened out and there are many more individuals or circumstances involved, then that's one kind of

explanation as to why the clock seems to be running here without any sense as to some conclusions.

I'm not trying to get into specific cases, but I think we've got to have a somewhat better understanding as to why it is that the earlier expectation that we were given has changed as much as it has. Is it because we now have many more investigations underway or what has happened here?

Mr. RUDER. That's an entirely appropriate question, Senator. You may remember that we started with Dennis Levine. We went to Ivan Boesky. And as I understand it, at the time at which Chairman Shad testified, those were the two main cases.

Since then, the Commission has successfully brought the Siegel matter forward and the Kidder Peabody case which was brought forward. There's some question about whether Siegel preceded or succeeded Chairman Shad's testimony, but the Kidder Peabody case did succeed it. It involved a substantial Insider Trading Sanctions Act penalty and was an outgrowth of those cases.

I may say that we are not necessarily confining ourselves to insider trading cases in light of the leads that we have had. There are many other cases which are not strictly insider trading cases. You may remember as well that there was a reference to some matters in London which came out of this, in which our cooperation with the English authorities was helpful.

I might say one other thing which is of concern to me personally, and I have observed this since I've become Chairman of the Commission. We have every week a closed meeting of the Commission to deal with enforcement cases. These meetings sometimes last as many as 3, 4 or 5 hours and we deal with numerous matters involving insider trading.

What has struck me has been not only the fact that insider trading is a crime and a securities law violation which exists within the industry, but the ordinary American citizen apparently is not yet willing to recognize his or her responsibility to refrain from insider trading.

FAMILY CONNECTION CASES

We have been dealing in many cases with what I call the family connection cases in which somebody inside a family learns information and transmits that information to other members of the family who then go on to trade.

I regard that conduct as reprehensible—perhaps not as reprehensible as conduct by a securities professional, but nevertheless, reprehensible. And I think that if we are going to have securities markets which are fair and have securities markets upon which others can rely, we need to prevent people in all walks of life from engaging in this activity.

So what I'm saying to you is that we are expending resources not only with regard to the big cases, but a continuation of other kinds of insider trading cases. And as I indicated to you earlier, insider trading cases most frequently require so-called circumstantial evidence rather than direct testimony by people who say, "I did it and I gave the information or I received it." Those cases are so fact-intensive that they require extensive documentation. I know I'm

giving a long answer, but I have one other point to make, and that is, the larger the defendant's potential liability, the more complex the problem, the more that we can expect strong and vigorous representation on the other side.

We are opposed by literally hundreds of lawyers in these complicated cases with numerous motions and complicated legal points, and it has the effect both of slowing down our ability to bring these cases and the effect of using our resources. We try not to be public in the investigatory stage because we think that may be unfair.

Senator RIEGLE. Let me just conclude it this way, and then I'm going to yield to Senator Bond. I think this story today on page 5 of the Wall Street Journal is a major story. I think it has a major impact to people who follow the market system closely and it suggests a very disturbing situation.

We can't probe with you here the details of what underlies these kinds of very strong assertions in this presentencing letter that has been sent to the judge in the Boesky case, but I do think we could benefit from additional information.

I don't want you to have to just try to look for phrases here in this public setting with responses off the top of your head.

I think we need to get a statement from you, a public statement, which you can take a few days to devise. I think that would give us a better sense of what's going on without compromising the cases you have underway. For example, are we talking about two or three cases? Are we talking about dozens of cases? Are we talking about a problem that is spread out in a much broader way into new areas of difficulty? Are we talking about something that's global in scope?

I think we need some sense of the scale of this problem and you can do that without tipping your hand or getting into cases and it relates, frankly, to your request for more resources as well.

You've said today that you need the budget request that's been sought by the administration and I fully agree with that. But part of the reason you need it, presumably, relates to the work that is going on here.

So I would ask you within the next day or two to confer with your people and see if you can't make a statement providing a meaningful response that gives us a clearer sense of the scale and the scope of this investigation than what you are able to do in an ad hoc fashion today.

Mr. RUDER. I will be pleased to do that, Senator, and do so within the confines of confidentiality and fairness and it will indicate both in terms of the numbers and complications and timing where we are.

BUDGET INCREASE NEEDED FOR ENFORCEMENT

One comment on the resources. We have within the Commission transferred resources from the market regulatory, corporate finance, and investment management areas to enforcement, and our 1988 budget had a very large increase also for enforcement. First, we are in a very difficult situation at this point with regard to resources. We have moved resources from those areas—investment management particularly, and market regulation—where we need

to increase resources, but we can't take back those resources which we've given to enforcement without jeopardizing our enforcement programs.

So the market matters and the enforcement matters are very much intertwined with our 1988 budget, and I will say as well our 1989 budget, but that's not really here at this point.

Senator RIEGLE. Thank you.

Senator Bond.

Senator BOND. Mr. Chairman, I commend you for your concern over the resources and I hope that you will share with us a copy of your letter because I would like to join with you in expressing the urgency of providing adequate resources to the enforcement section of the SEC.

Chairman Ruder, it's obviously going to be a very close question when we get down to defining how a multiservice firm can or cannot trade and you have suggested that the "in possession" rather than "use" standard is appropriate.

I'm not sure exactly what you mean in your testimony by saying that "reasonable policies are in place." What would you expect to see in a Chinese wall and how must a securities firm educate its employees to implement such a wall?

Mr. RUDER. Well, first of all, we're talking about the segregation of people, segregation of the people who are making essentially underwriting decisions and those who are engaged in trading decisions, both in terms of trading by the firm in their arbitrage activity and trading in the sense of giving advice to others. The first level of importance for this is to separate those two activities and to keep one group of people from communicating with others regarding information in their possession. So in that regard, it is simply a sense of physical separation which is important.

Additionally, there's the concept of a restricted list, a list of securities in which transactions may not be made without having the approval of persons within the firm. And I think the firms with the best programs, have established a procedure within the firm so that if a trading decision is to be made on a security on the restricted list there must be a consultation with the compliance officers within that firm to be sure that the Chinese wall has not been breached, to be sure that the protections are in place.

Senator BOND. Are you suggesting that not only is physical separation necessary, but if Fred is in M & A and Harry is on the trading side, they can't even have lunch together. Is that fair?

Mr. RUDER. Well, it may not go that far, but you would certainly want to restrict their activities as far as you could and certainly you would admonish them not to discuss particular companies when they were having lunch or cocktails together.

Senator BOND. I would just say I appreciate the answer, but this is one area where I think the small investor really does question whether the system is fair when he sees one company may be involved in it and yet the company also is providing him investment advice, and I think that the Chinese wall is a concept that doesn't have uniform credibility, and I was interested in your views.

THE FINANCIAL ANALYST SITUATION

Let me move to another subject and that is the financial analyst situation. I noticed in your discussion, I think footnote 21, you say that you don't think the Commission's proposal would reverse the result in the *Dirks* case and yet you say that routine communication from analysts, communications not in the breach of duty, would be protected.

I'm a little bit troubled. I don't know exactly how analysts work, but I understand they are continually calling officers of a company asking questions and it is quite likely that by asking enough questions maybe from several different officers they can come up with something that is not public information.

Obviously, in the *Dirks* case, some good analysis put him in possession of some very material information a lot of people didn't know.

What kind of protection are you going to propose for the analysts? How can the analysts stay out of the trip and yet ask the questions that they need to ask?

Mr. RUDER. The first answer is specific. With regard to the *Dirks* case, the legislation we have proposed would have protected Dirks in that situation. Dirks received information from an employee who was communicating the wrongful nature of the corporation's conduct and therefore was not under any duty of confidentiality. So that Dirks would have been able to receive that information and pass it on, at least as we understand it, without having a problem.

Senator BOND. But only because it was wrongful?

Mr. RUDER. Only because it was wrongful.

Second, I think that the legislation clearly would maintain what is called the mosaic theory, the mosaic theory being the situation in which the analyst has essentially done research and has put a bunch of pieces together and calls the company and gets the final piece which, when put together with other information, then gives the analyst the material piece of information which the analyst wants. In that case, the analyst would be protected because the information which had been received would either not be material in itself—that is, very important—or probably would not have been communicated wrongfully from the corporate officer.

The third answer here really does deal with both the wrongful nature of the communication from the corporate officer to the analyst and to the mental standards which are contained in our proposal. We use the phrase "knowing or recklessly disregards." As we have used the words "recklessly disregards," we use them in the sense of those cases which deal with warning signals. We do not impose upon the analyst by the use of that phrase the obligation to make further inquiry to the corporate officer.

So that if the corporate officer indicates he is making a public communication to the analyst, the analyst is entitled to rely upon that and to think that the communication will not be wrongful. On the other hand, if you have a situation in which the corporate officer says to the analyst, "I want to give you a hot piece of inside information; it's confidential and don't use it," we don't think that the analyst should be able to go out and tell his clients that information and benefit from it.

Senator BOND. Well, I would agree with you, but I doubt that the situation is always so clear-cut. It seems to me that we don't always have a situation in which the officer says, "That is public information" or "This is a hot inside scoop," and I trust that your regulations that you will propound will shed more light on this and give some guidance because I think it's very important to know how analysts can appropriately acquire information.

Mr. RUDER. I'd like to add two comments to that, if I may, sir.

One is that I want to emphasize that the Commission has enforcement discretion, and that the Commission is going to exercise that discretion carefully when it deals with analysts.

We believe it important that the analysts be encouraged to obtain information from companies and that the analysts communicate that information.

Second, with regard to private cases which may involve analysts, I could expect that courts would have the same kind of concern when dealing with factually-intensive matters, such as whether the fact is material—that is, very important—or whether the information was public, or whether the information was wrongful, I would expect courts and other triers of fact to be aware of another policy underlying our securities laws—that the disclosure of information in appropriate circumstances to be encouraged.

FIRMS LIABLE FOR ACTION OF EMPLOYEES

Senator BOND. One final question. I want to give you an opportunity perhaps to comment on some testimony that is going to follow yours. I believe in reviewing some of that testimony, there is a contention that the proposal of the SEC would hold firms too broadly liable for the actions of their employees. I believe you have spoken publicly on this and would you care to give your views on the responsibility of firms for their employees' actions? Again, we may be hearing some other comments on that today.

Mr. RUDER. Well, we have in subsection (b)(2) a defense for entities, which provides that an entity will not be subject to liability when it has put into effect the equivalent of a Chinese wall policy and, in addition, no individual involved in making investment decisions knew of the information or was influenced by it.

So in one sense, the activities of employees who are collaterally causing trades to be made will not cause the firm to be liable.

Second, we have included a section on what might be called controlling person liability which is subsection (e), which says, "[N]o person shall be liable under this section solely by reason of the fact that such person controls or employs a person who has violated this section * * *." The intent of that is to indicate that the common law doctrine of respondeat superior is not directly applicable in these cases, but we do then have a caveat to that which says "if such controlling person or employer did not participate in, profit from, or directly or indirectly induce the acts constituting the violation of this section." So we have put in here a limited kind of defense in that kind of situation.

Senator BOND. Do you think it's fair with that limited defense to hold them responsible in other cases? Do you think this is fair?

Mr. RUDER. I believe it's a fair reconciliation of the respondeat superior doctrine, which is a doctrine which says the employer is automatically going to be responsible for the wrongdoings of the employee without more, and the concept that an employer owes some responsibility to the public by holding out his employee, and we believe that our draft has the appropriate reconciliation of those very difficult problems.

Senator BOND. Thank you, Mr. Chairman. I see the red light is finally working.

Senator RIEGLE. Thank you, Senator Bond. I think those were very important questions. This really helps us develop this record and is very useful to our effort.

Senator Hecht.

Senator HECHT. Thank you, Mr. Chairman.

Good morning, Mr. Chairman.

Mr. RUDER. Good morning.

Senator HECHT. Briefly, unfortunately with our time constraints we don't get all parts of these hearings, but from past hearings, you are working up a set of recommendations completely independent; is that correct, on what can be done about insider trading?

Mr. RUDER. We have taken S. 1380, and we have worked carefully with the ad hoc committee under the chairmanship of Harvey Pitt. We've worked at the staff level to develop a bill which we felt came much, much closer to S. 1380, and a bill which could be supported by the Securities and Exchange Commission.

I would like to emphasize that we have gone back and reviewed our prior submission to you and have come back to you with a bill which is much closer to the original draft but is now also supported by the Commission. So I believe that the work of the subcommittee and the ad hoc committee has produced a bill which can be adopted.

Senator HECHT. Do you feel legislation is needed at this time?

MISAPPROPRIATION THEORY

Mr. RUDER. Yes, I do. I think that the *Winans* case, although a victory for the Government in preserving the misappropriation theory in the 2nd Circuit, still leaves us with uncertainty should an additional justice be appointed to the Supreme Court, and still leaves us with uncertainty with regard to the law in the circuits other than the 2nd Circuit.

We think the misappropriation theory is an important theory because it allows the law to subject persons other than corporate insiders to the insider trading prohibitions. What we've had is a movement of the law away from the traditional corporate fiduciary theories as a means of controlling corporate officers and directors and insiders as they deal with their shareholders and to a view of the insider trading laws as being important for the protection of the integrity and soundness of the securities markets.

We believe that the adoption of the misappropriation theory based, as we believe it should be, soundly upon duty concepts will give us the kind of protection for the markets that we need, but will also preserve a sense of fairness for the people who are involved.

Senator HECHT. My only concern, in your talking, you sound like a Wall Street attorney representing the securities industry. I'm just a businessman for 35 years, so I've been investing. Scandals have rocked Wall Street since Wall Street has been there, and I'm always concerned that we overreact to a scandal and to headlines in the paper. Do you have any fear of that?

Mr. RUDER. No, I do not. Again, I'd like to emphasize the concept that one will be subject to sanction under this bill if one has breached a duty, a duty of confidentiality which seems to me is a sound proposition. After all, if a Wall Street firm entrusts its employees with information or a newspaper entrusts its employees with information or a Government entrusts its employees with information, those people should not be able to run out in the securities markets and make a lot of money through abuse of that trust.

It seems to me that the businessmen of America ought to like the fact that there would be a law out there that imposes the same kinds of duties on people in other circumstances that are imposed upon corporate insiders who have always had those obligations.

Senator HECHT. So you feel this is one defect that is being taken care of then?

Mr. RUDER. Yes, I think that's the primary defect.

Senator HECHT. The primary defect right there, which is not addressed at this time?

Mr. RUDER. Well, it is under the *Winans* decision, under the 2nd Circuit misappropriation theory, and I regard that as being a law which is good, but which is in a state of uncertainty because of the four-to-four decision.

Senator HECHT. Thank you very much.

Mr. RUDER. You're welcome.

Senator RIEGLE. Thank you, Senator Hecht.

Later this morning the Securities Industry Association is going to raise a number of concerns with respect to the proposal that's been submitted by the Commission and I'd like to get your reaction to two or three of these issues.

First of all, they complain that the liability for multiservice securities firms is too tough. What is your reaction to that?

Mr. RUDER. Well, that may be a twofold question. Again, as I've indicated, we have put into our provision a defense for these activities for multiservice firms. That is the defense which says that if you have reasonable policies including a Chinese wall in effect and the person engaging in the activity didn't have and wasn't influenced by the information, you'll be all right.

I think that some of the other versions of the bills would lessen the importance of the Chinese wall provision, and what we are looking for in this bill is not only a protective device but also a prophylactic device, a device which will encourage these firms to set up these procedures. We say that if you have these procedures set up, that will be an important ingredient in your defense.

With regard to the extent of liability, our bill limits private damage liability to the amount of contemporaneous trading by the particular firm, so that's a limit. And we have an expansive definition of liability only with regard to those activities in which there can be a showing of cause, that the insider trading activities actu-

ally caused other kinds of damages. I don't think that's an astounding or revolutionary concept in our law.

All of these antifraud laws are tort related—civil liability tort related laws—and they provide in that context—in the context of this liability provision—the same kind of requirement to show causal connections. I think therefore that there are protective clauses.

Senator RIEGLE. Now you're also going to hear from the industry that they think that the proposal chills what they consider the legitimate role of analysts in the free flow of information into the markets. What would be your reaction to that complaint?

Mr. RUDER. Well, I gave a quite extended answer to that to Senator Bond, and I would reiterate those points. I think the concept of wrongfulness which we have inserted into the communications section is a very important defense. I think we have clearly had the mental state provisions require knowing or reckless conduct disregard, and I would reiterate that we would, if this legislation were adopted, look very closely at the protection for analysts and may want to engage in rule-making to provide safe harbors. Therefore, we think it's very important that an exemptive provision be included here.

I might say that the concern among other members of the Commission, including the members who did not vote in favor of the Commission proposal, was essentially strongly based upon this concern about communication. And it's for that reason that we think that the exemptive rule making power is extremely important to us, so that we can deal with these problems as we see them and we would consider doing so.

Senator RIEGLE. Now the industry is also concerned over the use of a possession standard in the SEC proposal. I'd like you to just summarize what the current law is in this area and why you think the Congress should adopt the standard that you're recommending.

POSSESSION TEST VS. USE TEST

Mr. RUDER. The current law I would describe as not clear. We at the Commission believe that the law should be a possession test instead of a use test. There are others that say that the law is and should be a use test.

The distinction we mean to make is this. If an individual has inside information and nevertheless trades based upon that information, that individual may want to assert a defense that the reason for the trade was not because that person was acting upon the inside information but because the person had some other motive. I can make up one. Let's assume that the person was going through a divorce and needed to have liquid funds to pay off obligations and says:

> My reason for selling this stock was solely because I had these other obligations. Although I had this information in my possession, I did not use it because I had other reasons for selling.

First of all, we think that's not a good reason. We think that if you have that information in your possession, you should either seek disclosure of that information or refrain from trading. This is a rule which does not absolutely bar trading. It is a rule which in

the securities law is called a disclose or abstain rule. So that if you can disclose, then you can sell or buy your stock.

In an enforcement context, if we permit defenses saying, "Well, I had the information but I didn't really use it," we would allow defendants to get on the stand and present these defenses in circumstances which will make the enforcement of the law very difficult.

So from both a policy point of view and an enforcement point of view, we think that the use test is not the right test and that the possession test is the right test.

Senator RIEGLE. Very good. I think that adds a lot to the clarity.

One more question from me and then we'll go to my colleagues.

Later this morning you are going to hear from Mr. Bialkin that he believes that the term "material" should be defined in any statute on insider trading. Our proposals do not include such a definition.

I'm wondering what your explanation would be as to why a definition of the term "material" is not necessary.

Mr. RUDER. I think the lack of a definition reflects the difficulty of definition. The concept of materiality is one which has been in the securities law since 1933 and there has not been at the Commission an attempt to define the word material for any purpose.

The reason I think is a very good one. The concept of materiality is, again, a fact-intensive matter. In any resolution of statutes such as this, which have potential criminal implications, which have potential civil penalties, you need to have a device to give some latitude to the people who are determining whether criminal or civil liability exists. And I think that if you say to an intelligent court or an intelligent jury, "Now here are all of the circumstances. You decide whether or not under all the circumstances it was material." You give the people involved a chance to reach conclusions which may be more just and more fair.

Senator RIEGLE. Very good. I have a couple of other questions that I'm going to have you supply answers for the record.

Senator Bond.

Senator BOND. Thank you, Mr. Chairman.

I'm sitting here smiling because I'm reminded by your testimony on the subsequent fabrication of reasons for the trade of my very first pro bono criminal defense case and I attempted to convince a jury that my client didn't really realize he had gone off without paying for the gasoline until sometime later, and it took the good jurors about 20 minutes to find him guilty. And I think that your practical application and the description of the difference between the possession or use doctrine probably reflects the good common sense that most people would find.

I would only ask one question. You mentioned in one of your answers to me that in terms of controlling interest, you are in subsection 16(a)(e) you're saying that no person is liable solely by reason of employing or controlling another if such controlling person or employer did not participate in, profit from, or directly or indirectly induce the act.

Then down in the footnote, you cite section 20(a) in the Exchange Act, which says unless the controlling person acted in good faith and did not directly or indirectly induce the acts that constitute

the violation or cause of action. Is this 16(a)(e) meant to substitute for that provision in 20(a)? I don't have the full text.

Mr. RUDER. No, sir. The introduction to section 16(a)(e) says, "Except as provided in section 20(a) of this title * * *." So controlling person liability would continue to be applicable if section 20(a) standards were met, and it would also be applicable if the exception to our negative were found to be the case. So there really are two ways.

Senator BOND. Maybe it's a little clearer when one lays it out and reads it, but frankly I'm not totally confused but I'm getting pretty close trying to relate 16(a)(e) and 20(a). I mean, if the controlling person did not profit from the act, then does that or does that not imply something of good faith? The question is a technical drafting question. Do you gain by having those two double negatives or exemptions in there? Do you gain anything or do you just get it more confused?

Mr. RUDER. Well, we were concerned that if we put a provision which essentially says that you will not be liable if you control or employ a person, and then put in some other language which said that there nevertheless will be some areas in which the controlling person could be subject to liability, that we might be seen to be denigrating the force of section 20(a). We wanted to preserve section 20(a), so we put in two standards.

Senator BOND. Which is the better standard, 16(a)(e) or the 20(a)?

Mr. RUDER. Section 20(a) is more difficult to show. The section 20(a) standard provides a better defense than the latter part of our section 16(a)(e). They are slightly different, since section 20(a) has a good faith requirement in it.

Senator BOND. Section 16(a)(e) is if you get profit from it which probably would happen in most circumstances unless the controlled person were not trading for his own benefit.

Mr. RUDER. Well, that's the problem. Really if you want to look through what's happening, if you have a brokerage firm employee or a corporate employee trading for his or her own benefit, the question has been, well, does that automatically mean that because that person is employed by the institution or the corporation that the corporation or institution is liable? And I think we've made it pretty clear that that's not going to be the case. The mere employment will not subject the institution to liability.

If, on the other hand, the institution gets the money, we think the institution should be required to give the money back.

Senator BOND. Then shouldn't you amend 20(a) to have the same standard?

Mr. RUDER. No.

Senator BOND. If it's a better standard, why don't you use it in both places?

Mr. RUDER. Because section 20(a) is a slightly different provision. Again as I said, it was an indication on our part that we did not want to give the impression that we were abandoning section 20(a). We really have two ways here which are slightly different. One with the good faith defense in it; and one with these elements in it.

Senator BOND. If I were advising a client, I would be kind of hard-pressed to figure out which way to go.

Thank you, Mr. Chairman.

Senator RIEGLE. Thank you, Senator Bond.

Senator Hecht.

Senator HECHT. Just a couple of observations. I've had a smile on my face. Over the years, I think I have seen more money lost on insider trading than made on insider trading because it's always on tips and there's been tremendous amounts of money lost on these tips.

Just one observation to you, sir. I want to compliment you publicly. I think you've walked into a tough job at the most trying time, have acted in a very responsible way, given a lot of credibility to your position, and have been a very, very good control and influence on the market.

Mr. RUDER. Thank you very much.

Senator RIEGLE. Thank you, Senator Hecht.

Thank you, Chairman Ruder. We're pleased to have heard your testimony today.

Mr. RUDER. Thank you very much.

Senator RIEGLE. We will now have our next witness, Mr. Edward O'Brien, president of the Securities Industry Association. We would be pleased to have him come to the table with any associates that he has with him.

I will say as Mr. O'Brien is taking his seat, that we will then hear a panel of three other distinguished people and we will move on to them just as soon as we can. We are mindful of the time.

Mr. O'Brien, we would like to hear from you now. We will make your full statement a part of the record so any summary that you want to give us would be fine.

STATEMENT OF EDWARD O'BRIEN, PRESIDENT, SECURITIES INDUSTRY ASSOCIATION, ACCOMPANIED BY SAM SCOTT MILLER, MEMBER, ORRICK, HERRINGTON & SUTCLIFFE AND A MEMBER OF THE SPECIAL TRADING PRACTICES COMMITTEE, SECURITIES INDUSTRY ASSOCIATION

Mr. O'BRIEN. Good morning, Mr. Chairman, Senator Bond and Senator Hecht. I am Edward I. O'Brien, president of the Securities Industry Association. Testifying with me today is Sam Scott Miller, a partner in the law firm of Orrick, Herrington and Sutcliffe, and a member of SIA's Special Trading Practices Committee.

SIA set up this committee in late 1986 in order to consider the problem, to consider legislative changes which made sense, and to examine the changes in the procedures in the industry itself to combat the situation.

Mr. Miller, as I mentioned, is a member of that committee, and he is equipped to comment on many of the technical dimensions of the proposed legislation.

I want to state at the outset that our industry remains absolutely opposed to insider trading and I want to state that as emphatically as I can.

MINOR MODIFICATIONS NEEDED ON S. 1380

As you know, SIA has specifically endorsed S. 1380 with minor modifications. We believe this bill sets forth a responsible definition of the prohibitions against insider trading.

On the other hand, we were concerned about what we saw as some drawbacks of the Commission's original proposal. We believe that would have resulted in a chilling impact on the flow of information to the securities marketplace. It would also have exposed multiservice financial institutions to enormous liability in situations where they were not at fault but rather had the misfortune of hiring a malfeasant.

The revised SEC proposal, the so-called compromise, unfortunately, exacerbates these concerns. More important, given the Commission's clear victory in the *Winans'* case, we raise the question as to whether legislative action is any longer needed. We shall address first our specific concerns and then discuss the present need for this legislation.

The SEC proposal, like its predecessor version, S. 1380, recites that there is an important public interest in the prompt flow of information to the securities markets. The purpose, the SEC contends, is not to interfere with the dissemination of information but to punish its wrongful use, and we agree with that wholeheartedly.

We are concerned, however, that law abiding professionals may be hampered in performing desirable market function because they may not have been able to determine whether information received by them in an altogether legitimate fashion may nonetheless be obtained or transmitted by others in a manner that would taint its publication or use.

We submit that the means proposed by the SEC to reach its objective of punishing those who misuse information would also have the effect of chilling desirable dissemination of information.

Chairman Ruder recognizes the important role that analysts play in the publication of information. He suggests that the committee should provide clarification of or suggest exemptive relief from the provisions of the proposal that relate to analysts.

The language used in the SEC proposal, however, is difficult to qualify in a way that would allow analysts to obtain and pass on important information to the marketplace.

An analyst receives information from many sources and will frequently not be in a position to know the various motivations of the person providing the information. Hence, he cannot know whether such information may have been provided in violation of a fiduciary duty or another relationship.

The cumulative effect on the communications process of these disincentives will be to cut off the flow of vital information to the marketplace. We believe this can affect the investment decision process for individual investors as well as institutions.

SIA members, as well as their self-regulatory bodies, have recognized the importance of rigorous procedures to constrain insider trading by employees and, in fact, they have instituted extensive procedures to strengthen self-regulation at the firm level. These firms should not, however, be liable for violations in which they did not participate and they are not realistically within their control.

Notwithstanding that the firm meets the burden of establishing that individuals involved in investment decisions were untainted by material nonpublic information, under the SEC proposal, that firm must, in addition, prove that it had implemented procedures

designed to prevent the individuals making the investment decision from possessing the material nonpublic information.

We prefer the balanced approach of S. 1380 which recognizes that possession of information by some individuals should not automatically contaminate the actions of others. S. 1380 puts the procedures of a firm in their proper role—germane in determining whether it has sustained the burden of showing that investment decision makers were unaffected, but not necessarily depositive of that issue.

Now, Mr. Chairman, I will turn to Sam Miller, who will compare other aspects of S. 1380 with the SEC proposal as well as discuss the need for legislation.

Mr. MILLER. Thank you. I will first take up the possession standard. The SEC, like other law enforcement agencies, is concerned about the burden of proving violations and that burden would be lessened if trading while merely in possession of information was deemed culpable behavior.

POSSESSION STANDARD UNFAIR

Unfortunately, other objectives are adversely affected by that kind of a standard. We believe that the possession standard is unfair because it would create a disproportionate risk. We believe it's unwise because that would stifle desirable and perfectly proper activity and we think it's also unnecessary because, to our knowledge, the SEC has not been held back in any case by the difficulty of establishing that material nonpublic information formed the basis for trading. I don't think a jury has any more problem with insider traders than they did with Senator Bond's client when he stole the gasoline.

The SEC proposal would attach controlling person liability under Section 20(a) of the Exchange Act but exclude respondent superior liability if the employer is able to establish that it did not participate in, profit from, or induce the violation.

Congress recognized that it is appropriate to impose liability on a firm only when there is a truly meaningful participation by the firm in the Insider Trading Sanctions Act of 1984. There, it expressly attached the increased penalty to aiders and abetters but only to those who communicated material nonpublic information.

Moreover, the 1984 amendments provided that no person should be liable solely by reason of employing another person and that the controlling person's liability provision of the Exchange Act is not a basis for such penalty. The same concerns that motivated those constraints suggest the advisability of parallel provisions in the legislation under consideration.

Moreover, the scope of the phrase "participated in" is unclear. An individual violating this statute may incidentally use the facilities of a firm. For example, the wire and order system, or even its telephones. Such activity should not be deemed participation under the statute. While the employer may receive an incidental benefit, for instance, a commission, if the trade is executed through its facilities, this also should not cross the threshold of meaningful participation.

We further believe that it is inappropriate to find a violation on the part of a firm any time an employee is found guilty solely because a transaction was executed for the account of the firm or just because the employer may unwittingly realize a profit in connection with the violation.

In the absence of any other participation in or inducement by the firm, it is draconian to find a violation solely because the trade was undertaken for the firm's account or it profited because the violator used its services.

Similarly, a mutual fund or pension account should not be tainted by its advisers' violation.

The SEC proposal provides that any person injured by violation of the act other than a contemporaneous trader may also bring an action to seek recovery of any damages caused by the violation. We feel this provision is imprudent. It is one thing to provide damages to a contemporaneous purchaser or seller, but quite another to open the door to other actions that do not directly relate to the violation, especially with no limit as to amount.

The Commission has relied on the misappropriation theory, as Chairman Ruder indicated this morning, in a number of recent cases, and uncertainties surrounding this theory were the predominant concern leading to the call for new legislation.

The SIA suggested earlier in the year that if the Supreme Court overturned the lower court decision in *Winans,* it might be desirable to enact a separate provision to specifically redress this problem. Instead, the Supreme Court upheld the lower court decision and left the misappropriation theory standing.

Despite some contrary speculation, we believe the Supreme Court has dealt with this problem in a way that eliminates the need for legislative redress. Although the Court split four-to-four in upholding the misappropriation theory, it took pains to point out that the Wall Street Journal, from whom the information was misappropriated, was not a buyer or seller of the stocks traded in or otherwise a market participant.

Moreover, since the Court unanimously decided that misappropriation was fraud under the mail and wire fraud statutes, it is difficult to see how it would reach a different result applying almost the same fraud language to a purchaser or seller or market participant.

We infer, as we believe the Court intended us to, that presented with the misappropriation involving a purchaser, seller or other market participant, it would not have any difficulty finding a violation. If any difficulty in applying the misappropriation theory should arise, Congress can then repair the gap. In the meantime, the misappropriation theory is alive and well in the 2nd Circuit which is the venue for the vast majority of cases brought under this theory and we believe that other circuits will read the Supreme Court decision as we do.

In concluding, SIA believes S. 1380, with minor modification, does provide a paradigm for legislation. We also are concerned that in its commendable zeal to deter insider trading the SEC has lost sight of an overriding goal of securities regulation, the uninhibited dissemination of information concerning companies and their securities.

Finally, given the Commission's impressive victory in *Winans*, we question the need for legislation.

[The complete prepared statement of Edward I. O'Brien follows:]

STATEMENT OF

SECURITIES INDUSTRY ASSOCIATION

Chairman Riegle and Members of the Subcommittee:

I am Edward I. O'Brien, President of the Securities Industry Association. Accompanying me today is Sam Scott Miller, a partner in the law firm of Orrick, Herrington & Sutcliffe and a member of the SIA's Special Trading Practices Committee.

The Securities Industry Association[1] would like to express its views with respect to proposed insider trading legislation, particularly S. 1380 and the Proposed Insider Trading Bill submitted by the Securities and Exchange Commission on November 18, 1987 (the "SEC Proposal").

As you know, the SIA has in the past supported the idea of a legislative definition of insider trading and, with minor modifications, specifica ly endorsed S. 1380, The Insider Trading Proscriptions Act of 1987, the bill introduced by you earlier this year. We believe that S. 1380 set forth a responsible definition of the prohibitions against insider trading.

We were concerned about what we saw as serious drawbacks of the Commission's original proposal. We believed that its provisions would have resulted chilling impact on the flow of information throughout the securities marketplace. It would lso have exposed multi-service financial inst tutions to enormous vicarious liability in situations where they were not at fault, but rather had the misfortune of employing ma feasor.

The revised SEC Proposal, a so-called compromise[2], in no way alleviates these concerns; indeed it significantly exacerbates them. More important given the Commission's clear victory in the *Winans* case[3] we question whether legislative action is even needed at this time. We shall address first our concerns with the SEC Proposal and then discuss the present need for this legislation.

Interdicting the Flow of Information to the Marketplace

The SEC Proposal, like its predecessor version and S. 1380, is prefaced with the finding that there is an important public interest in the prompt flow of information to the securities markets. The purpose of this legislation, the SEC contends, is not to interfere with the dissemination of information, but to punish its wrongful use by prohibiting certain types of wrongful trading and communications.

Unfortunately, in its zeal to reach every instance of wrongful use, the Commission has thrown up barricades that would interdict the flow of all kinds of information into the marketplace.

The SIA fully supports the imposition of liability on anyone who obtains information by means of breaching a fiduciary duty personal other relationship of trust and confidence We are concerned, however, that law abiding professionals may be hampered in performing desirable market functions, because they may not be able to determine whether information received by them in an altogether legitimate fashion may nonetheless have been obtained or transmitted by others in a manner that would under the SEC Proposal taint its publication or use We submi that the means proposed by the SEC to reach its objective of punishing those who misuse information would also have the effect of chilling desirable dissemination of information.

As we read subsection (b)(1) of the SEC Proposal, this chil would spread ll beyond the securities markets. A newspaper reporter for example, without any derilection of his duties or responsibilities, might receive information about a corporation that is a product of breach of fiduciary duty or relationship of rust and confidence. If he realizes that there has been breach or if it is later determined that he "recklessly disregarded the breach -- and personally buys or sells a security, he has, of course, violated the prohibition of wrongful use. However, if he does not trade, but merely prints the information, he would nonetheless be vulnerable under subsection (c). Singleminded attention to the potential for abuses should not blind us to the more foreboding specter of information control that this scenario raises.

Further, those who counsel corporate management are familiar with the common reluctance to divulge unfavorable information and the justifications that are drawn upon to delay its release, for example, "running more numbers". The SEC Proposal effectively intimidates the analyst or financial writer who might otherwise be the first to disseminate the information into the market place. This reluctance would undoubtedly be exploited by management trying to delay or avoid the dissemination of negative information about their company.

Finally, corporate officials who do communicate information are placed in jeopardy of a later finding that they were reckless in not knowing that their communications were made in violation of fiduciary duties, including the duty of care. The cumulative effect on the communications process of all these disincentives to provide information, coupled

with the penalties for errors in judgment -- criminal prosecution and multiple damages -- will be to cut off the flow of vital information to the marketplace.

Restraining Analysts

Chairman Ruder's letter accompanying the SEC Proposal recognizes the important role that analysts play in the dissemination of information, and suggests that the Committee report should emphasize this role and provide clarification of or suggest exemptive relief from, the provisions of the proposed bill as it would relate to analysts.

The language used in subsections (b) and (c) of the SEC Proposal, however, is difficult to qualify in a way that will allow analysts to obtain and pas important information to the marketplace. An analyst receives information from many sources and wi requently not be in a position to know the various motivations of the individual providing the information, and hence whether such information may be provided in violation of a iduc ary duty or any other relationshi Even when ing routine matter individual source is likely to be prompted in ways that re difficult to discern and given the potentia ly broad sweep of concepts such as trust and confidence" analysts could unwittingly become liable despite any precautions they might take. Each would be subject to continual risk tha he was reckless in not knowing an insider had provided information.

Analysts perform a valuable function for the public in disseminating information; we believe they should be permitted to analyze he information provided to them, instead of being required to psychoanalyze the motivations of the person providing it

The Proper Role of Procedures

Imposition of liabi ity on an employer based on acts committed by an employee is of great concern. The SIA and its members, as well as thei self-regulatory bodies, have recognized the importance of igorous policies and procedures on the part of securities to train opportunities for insider trading by employees These firms should not, however, be liable for violations in which they did not participate and that are not realistically within their control.

Subsection (b)(1) of the SEC Proposal imposes liability for the wrongful use of material, non-public information. Subsection (b)(2) goes on to recognize the multiple capacities in which a firm may legitimately operate by providing that a firm may show that it has not wrongfully

used information if it establishes that no individual involved in making the investment decision or causing others to purchase sell knew or was influenced by the information Notwithstanding that the firm meets the burden of establishing that the individuals involved in making or influencing investment decisions on its behalf were untainted by material non-public information, under the SEC Proposal it must in addition prove that it bad implemented policies and procedures designed to prevent the individuals making the investment decision involved from possessing the material non-public information.We do not believe this requirement is appropriate and we instead support the more balanced approach of S. 1380.

1380 recognizes that in a large firm different functions could be carr ed on autonomously, and possession of information by some individuals does not and should not automatically contaminate the actions of others acting independently within the firm. In addition, S. 1380 places on the employer the burden of proving that the material, non-public information was effectively quarantined in the particular situation s that the transaction in question was not infected. S. 1380 also puts the po icy and procedures of firm in their proper role: germane in determining whether a firm has sustained its burden of showing that investment decision-makers were unaffected, but not dispositive of that issue The po icies and procedures of a irm may in some cases be the most significant evidence available In other instances may be poss le to establ sh exactly what has occurred or not occurred without any resor to an examination of the fi 's policies and procedures. The language of 1380 works equally wel in both situations, using all information that is relevant and not requiring a lengthy analysis of extraneous factors if they are not pertinent.

It is appropriate to recognize the efforts that firms take to implement and maintain policies and procedures, for this is an effective way to discourage improper activity by individuals S. 1380 considers the relevance of policies and procedures in its proper perspective and provides more than adequate incentive for firms to handle their internal affairs so that opportunities for illegal activity are diminished to the maximum feasible extent.

The Possession Standard

The SEC ike other law enforcement agencies, is concerned about the burden of proving violations of the tatutes administers. That burden would be lessened if, as in the SEC Proposal, trading by an individual or entity while merely in possession information were deemed culpable behavior. Unfortunately, other objectives are adversely affected by this possession standard.

We have discussed above the problems a securities firm faces when acting in various capacities. S. 1380, with minor modifications, strikes a balance of being an effective deterent of undesirable market behavior while appropriately avoiding any chill on the free flow of information due to unrealistic standards or unfairly disproportionate derivative sanctions.

We believe that the Commission's decision to impose liability based on a possession of information -- instead of a rebuttable presumption arising from possession of information -- is fundamentally unfair, unwise and unnecessary. The act that makes insider trading wrong is the way information is used, not just having it. A possession standard is unfair because it would create a disproportionate risk (especially given the sanctions that could be invoked under the Insider Trading Sanctions Act), unwise because that would stifle desirable and perfectly proper activity, and unnecessary because, to our knowledge, the SEC has not been held back in any case involving trading by an individual who knew the material non-public information by the difficulty of establishing that such information was a basis of the trading.

We understand that a possession standard might make it easier for the Commission to prove its cases in some circumstances, but our reading of the case law indicates clearly that a basis standard is now universally applied (even in those cases where courts loosely use possession language) and the Commission has not had any difficulties in meeting this standard.

Derivative Liability

The SEC Proposal would attach controlling person liability under section 20(a) of the Exchange Act, but exclude respondent superior liability if the employer is able to establish that it did not participate in, profit from or induce the violation.

Congress recognized that it is appropriate to impose liability on a firm only when there is truly meaningful participation by the firm as recently as 1984 in the Insider Trading Sanctions Act. The amendments to section 21(d)(2) of the Exchange Act expressly attached the increased penalty to aiders and abettors, but only to those who communicated material, non-public information. Moreover, the amendments provided that no person shall be liable solely by reason of employing another person who is liable and that the controlling-persons liability provision of the Securities Exchange Act is not a basis for such penalty. The same concerns that motivated those constraints also support

inclusion of a provision in the legislation under consideration that would not find a firm liable unless it engages in culpable behavior or is actively involved in a wrongful use or communication of information.

Moreover, the scope of the phrase "participated in" as it stands in subsection (e) of the SEC Proposal is unclear and does not provide guidance for application in particular circumstances. An individual violating the statute may incidentally use the facilities of a firm, ranging from execution of a transaction through the firm's wire and order system to placing a telephone call from the employer's office. Such activities do not rise to the level of meaningful "participation" on the part of the employing firm and should not be deemed to be participation under the statute. While the employer may receive an incidental benefit such as a commission if the trade is executed through its facilities, this also does not cross the threshold of meaningful "participation" if there is not otherwise culpable behavior on the part of the employer.

We further believe that it is inappropriate to find violation of the statute on the part of a firm any time an employee is found guilty solely because the transaction in question was executed for the account of the employer firm or just because the employer may unwittingly realize a profit in connection with a violation. If the employer profits from such a transaction, we do not question that any fruits of the violation should be restored to the injured person. But in the absence of any other participation in or inducement, directly or indirectly, by the employing firm, it is draconian to find a violation on the part of the firm solely because a trade was undertaken for its account or it profited because the violator used its services. While any such violation is regrettable, so long as the firm is not otherwise in any way culpable it is fortuitous that benefits of the violation were inadvertently realized and this should result only in restitution of any benefits to the appropriate persons, not rigidly imposing liability on the firm based on actions of the employee alone.

Employing firms should not be liable unless the action taken on the firm's behalf is accompanied by a failure of the firm in that instance to live up to its own obligations. These obligations should be measured not by examining the capacity in which the employee purported to be acting when the employee committed the offense, but by whether the firm took or failed to take actions that should subject the firm to liability. Congress decided this principle should be the basis for derivative liability in 1984 and nothing that has happened since suggests that it was in error.

Damages

The SEC Proposal provides in subsection (g)(1)(A) that any person who violates the Act shall be liable in an amount up to the profit gained or loss avoided (with offset for any disgorgement already made) to an individual injured by the contemporaneous purchase (where the violation was a sale) or sale (where the violation was a purchase) of the securities involved in the violation. Subsection (g)(1)(B) provides that any person injured by a violation of the Act, other than one entitled to recover under subparagraph (1) (by which we presume it means subparagraph (1)(A)), may also bring an action to seek recovery of any damages caused by the violation. We feel the latter provision is imprudent as well as unnecessary. It is one thing to provide damages to a contemporaneous purchaser or seller of securities, but quite another to open the door to other actions which do not directly relate to the specific transaction that is the subject of the violation, especially with no limit on their amount. This is an invitation to the imposition of liability and a proliferation of litigation plumbing the depths of this provision well beyond that which should be countenanced.

Market Information

All manner of information flows into the trading arena. For legitimate reasons, some persons have earlier, better access to, and may be able to trade on, that information without violating either existing or proposed law. Stock exchange specialists, market-makers, traders and other securities professionals are exposed in the ordinary course of their duties to all kinds of information that, either particularly or in the aggregate, may affect trading decisions. These professionals are frequently trading in diverse ways simultaneously in the regular course of trading.

To require in every trading situation an evaluation of whether market information was obtained through breach of a fiduciary duty or other relationship of trust or confidence would create great confusion. This confusion would severely inhibit legitimate and desirable trading activities, hence the vital liquidity of the securities markets, even though the behavior affected does not constitute a breach of any of the duties owed by the securities professionals or their organizations.

For this reason, we are concerned about the potential reach of the SEC Proposal to include market information. The idea that information about the market for a security or group of securities can be a type of material, non-public information has with limited exceptions (for

instance, in the context of tender offers) not been developed in the case law, and its application under the SEC Proposal is unclear.

Much of the information in a securities marketplace, such as the bid and ask quotes and trading volume, is the essence of public information, even though the ability to interpret and respond to that information is easier for an experienced professional standing on a trading floor than it is for a non-professional reading the information in the morning paper. This inherent difference in the access to and capacity for interpreting information is inseparable from expertise and professionalism. It is in the best interest of the public that securities professionals play a role in the diffusion of information and not be inhibited by a vague possibility that full participation in the market might infect them under the statute. For these reasons, and because the parameters of what would be material, non-public market information have never been defined, we recommend that if there is to be legislation, it be accompanied by interpretative positions that limit its application to information relating to the market for a security to precisely identified situations, such as tender offers.[4]

Please understand that we do not mean to suggest that under no circumstances should market information be relevant to acceptable behavior by securities professionals. Between the ambit of market information already covered by rule 10b-5 or rule 14e-3 and that which is clearly permissible for use by any trader is the penumbra reached by self-regulatory organizations. SROs have been active in evaluating situations where abuse is possible. They have brought enforcement actions in certain cases,[5] proposed rules for dealing with potential problems,[6] and issued interpretive positions and educational circulars.[7] In the technically complex trading markets, the expertise of those organizations is most effectively brought to the task of formulating and enforcing preventive procedures. Self-regulatory organizations are uniquely able to propose solutions that are effective, yet do not upset the delicate balance of the marketplaces.

An example is the review by stock exchanges of unusual trading activity for the account of a firm prior to a recommendation by an analyst employed by the firm. SROs have in such situations brought about corrective action through the exchange's disciplinary procedures. At the same time, self-regulatory organizations are sensitive to other responsibilities of a firm, such as continuing to make a market in a security to accommodate public orders. These situations require a balanced approach that can correct abuses without inhibiting the liquidity of the marketplace and the

free flow of information that fosters the activity creating that liquidity. We believe that self-regulatory organizations can best deal with most forms of abuse of market information and that, in general, this area of regulation should be delegated to them.

The Misappropriation Theory and the Need for Legislation

The Commission has relied on the misappropriation theory in a number of recent, well-publicized cases. Uncertainty surrounding the misappropriation theory as a basis for liability was predominant among the concerns that originally led to a call for an explicit statutory definition of insider trading.

We suggested earlier that if the Supreme Court overturned the lower court decision in *Winans*, it might be desirable to enact a separate provision that specifically addressed the imposition of liability based on the misappropriation theory. Instead, the Supreme Court upheld the lower court decision and left the misappropriation theory standing.

Despite some speculation to the contrary, we believe the Supreme Court has dealt with this problem in a way that eliminates the need for legislative redress. Although the Supreme Court split 4-4 in upholding the Second Circuit's imposition of liability under the Exchange Act based on the misappropriation theory, it took pains to point out that the Wall Street Journal, from whom the information in that case was misappropriated, was "not a buyer or seller of the stocks traded in or otherwise a market participant". Moreover, since the Court unanimously decided that the misappropriation in issue was fraud under the mail and wire fraud statutes, it is difficult to see how it would reach a different result applying almost the same "fraud" language to a purchaser, seller or other market participant.

We infer, as we believe the Supreme Court intended that we should, that presented with a misappropriation involving a purchaser or seller or other market participant, it would not have any difficulty finding a violation.[8] If any difficulty in applying the misappropriation theory arises in the future, Congress could then repair the gap in the securities laws. In the meantime, the misappropriation theory is alive and well in the Second Circuit, the venue for the vast majority of cases brought under the misappropriation theory, and we believe that other circuits will read this Supreme Court decision in *Winans* as we do. Therefore, there is no longer an urgent need to enact legislation relating to misappropriation.

Conclusion

SIA believes that S. 1380 with minor modification provides a paradigm for a definition of insider trading. We commend the SEC for its efforts to draft a definition but suggest that it reconsider how its proposal departs from S. 1380 in ways that would subordinate the free flow of information to the control of information. In its commendable zeal to deter insider trading it has lost sight of what to us is an overriding goal of securities regulation: the uninhibited dissemination of information concerning companies and their securities as rapidly as feasible. Finally, we suggest that given the Commission's impressive victory in *Winans*, the need for legislation is no longer clear. Especially in light of the impediments to the flow of information that are inherent in the SEC Proposal, we submit that Congress should await the aftermath of *Winans* before moving forward with legislation. We predict the perceived need will grow dim, if not imperceptible.

Footnotes

1 The Securities Industry Association consists of more than 500 securities firms located throughout the United States and Canada. Its membership inc udes secur ties firms of all kinds, including investment banks brokers, dealers and mutual fund complexes SIA members are active in all markets and in l phases of corporate and public inance Collectively, SIA members provide investors with ful spectrum of securities and investment services and account for approximately 90% of the securities business in North America.

2 While the letter dated November 18, 1987, of David S. Ruder, Chairman of the Commission, refers to meetings of the Commission staff with "representatives" of the Ad Hoc Legislative Committee, not all members of this Committee were consu ted as to either whom their "representatives" should be or as to the nature of the "compromise".

3 Carpenter v. United States, No. 86-422 (S.C. 1987).

4 By using this example, do to endorse the Commission vague standard of knowing or recklessly disregard ng that nformation has come "d rectly or indirectly" from principa ayers that would doubt retroactively put many investors at undeserved judicial peril.

5 See, e.g., Smith Barney, Harris Upham & Co., Inc., Exch. Act Rel. No.21242 (Aug. 15, 1985), and PaineWebber Incorporated, NYSE Hearing Panel Decision 85-28 (March 22, 1985).

6 See, e.g., NYSE rule 98 and Annex rules 190 and 193 (permitting affiliations between specialists and diversified securities firms under carefully controlled circumstances.)

7 See, e.g., NASD Notice to Members 87-69 (Oct. 20, 1987) (front running of blocks); proposed rule change by NYSE, File No. SR-NYSE-87-36 (front running).

8 Indeed it is possible that had the government alleged fraud on investors -- as opposed to the Wall Street Journal -- in this case, an even more favorable result would have followed.

Senator RIEGLE. Thank you very much.

Let me just pose one question. Mr. O'Brien, I very much appreciate the support of the SIA for S. 1380 and I just wonder if, in brief, you can tell us what the minor modifications are that you would like to see made to it.

Mr. O'BRIEN. Well, let me start off, Mr. Chairman, and Mr. Miller may amplify on that. I think that one involves the damage question, which I think should be clarified. The opening of damages to an open-ended type of arrangement we think is something which should be addressed.

I think the personal benefit test is something which needs to be clarified. It tends to be a little bit ambiguous at the moment.

And let me turn to Mr. Miller for any other questions he may want to take up.

Mr. MILLER. Well, the third modification we would make would be to exclude market information from the purview of the statute. We believe market information, except in very specific situations such as tender offers where it is dealt with separately, should be left to the self-regulatory organizations.

The only thing I would add to the question about derivative liability is that we would propose to adopt the same provisions that are currently in the law under the 1984 amendments.

Senator RIEGLE. Thank you.

Senator Bond.

Senator BOND. I'm a little bit surprised that you think that everything is clear with respect to the misappropriation theory as a result of the *Winans* case. Do you think a four-four split on the Supreme Court, the fact that four members of the Supreme Court don't like the theory, is adequate reason to take a pass on this?

Mr. MILLER. Well, I don't think it's as ambiguous as some commentators have suggested. The Wall Street Journal was not a market participant, did not trade in the securities, and hence, under the language of 10(b)(5), it was really very difficult to reach them.

Senator BOND. But shouldn't they have been reached? I mean, shouldn't the *Winans* case have been reached?

Mr. MILLER. Well, Winans was reached.

Senator BOND. Yes, by mail fraud.

Mr. MILLER. I think you're dealing with a fairly unique kind of fraud. By and large, most insider trading has in fact involved market participants. Winans was a very unique case and he's gone to the slammer. There are tools to deal with the Winans.

Senator BOND. Mr. O'Brien, I might just ask you generally if you are concerned, particularly in light of what has happened this year, not just October 19 but prior activities, that there may be some loss of confidence in the general public in how they are being dealt with by the securities firms. Do you find that there is a concern by small investors, for example, that they are not getting a fair shake?

Mr. O'BRIEN. Not widespread, but that is not to say that there is no concern. That concern is expressed in the media on a more or less regular basis. There are people in our own industry who have expressed concerns about that and obviously some investors have from time to time.

So it is not something that we consider to be insignificant or unimportant. Witness the fact that as soon as the thing began to develop through 1986 at the end of the year, we set up a committee in order to take a look at it and to look at such questions as what legislation may be needed; but, more importantly, what internal steps should or could be taken within the firms themselves to strengthen the situation. And we felt that that was the best method to restore confidence if in fact it had been weakened.

Senator BOND. Frankly, we're hearing from our constituents. I can't speak for all the other Members, but there is a concern and I'm sure that you would agree that maintaining that confidence is an essential part of the success of the securities industry.

Mr. O'BRIEN. I totally agree with that.

Senator BOND. One thing that bothers me a little bit and I'd asked Chairman Ruder to comment on it. If a person is driving down the street and, say, the local grocery truck making a delivery slams into their car, you probably can recover damages to the car from the grocery company if they are delivering groceries.

If that same person then goes on down the street to a well-known reputable brokerage house and they sell him some securities and somebody on the other side knows that there are good reasons that those securities are not a good buy, he may not have a right of action unless he can show that the person who sold them to him actually used that information.

I just wonder if that isn't too generous a standard for a reputable securities firm.

Mr. MILLER. Well, I believe that individual has an action today. He certainly has an action against the broker. He also has an action against the firm under the Insider Trading Sanctions Act, unless the only involvement by the firm was the act solely of employing another person who's liable. If that's the only involvement, then he can not recover against the firm. But if the firm goes beyond that in any culpable way, then he can reach the firm.

Senator BOND. A grocery store owner doesn't have that same kind of protection, does he, if his car hits somebody?

Mr. MILLER. A securities firm doesn't have that same kind of protection except in the instance of insider trading. That's a crime that takes place in the mind. And as Chairman Ruder testified earlier today, it is very, very hard to reach. A securities firm has greater responsibility under the controlling person sections of the securities laws in most circumstances than the grocery store owner has. Those provisions reach well beyond what we know as respondeat superior.

It is only in the area of insider trading where there is no policy served. The firm cannot reach into the mind of the individual. There's no procedure that will screen out information received in that mind. Therefore, it becomes much more unfair to make the firm liable in that instance.

Senator BOND. But don't you think the Securities and Exchange Commission provides certain things that the firm can do by establishing the Chinese wall and taking whatever reasonable procedures, as Chairman Ruder said, to assure that that information is not communicated?

Mr. MILLER. Well, Senator, I sat in this room 3 years ago when the Commission promised to provide rules under the Insider Trading Sanctions Act, and those rules have never emerged.

Senator BOND. Would you say that no definition of insider trading is preferable to the reconciliation draft?

Mr. MILLER. I'm sorry?

Senator BOND. No statutory definition—would you rather just pass on it, even though they are talking about increased sanctions and we get all geared up and talk about greater sanctions, would you be happier with no definition than the definition in the SEC proposal?

Mr. MILLER. I think that I would be. I do think that S. 1380 is a satisfactory compromise.

I think what we've seen in the processes subsequent to S. 1380 have given support to those who argued that perhaps we should content ourselves with the judges deciding what's insider trading.

Senator BOND. Thank you, Mr. Chairman. Thank you, gentlemen.

Senator RIEGLE. Thank you, gentlemen.

Our next witnesses are Mr. Donald Langevoort, Mr. Ken Bialkin, and Mr. James Cox. If they are here I would ask them to come to the table now.

Let me welcome all of you to the committee today. Professor Langevoort, it's nice to have you here as a Visiting Professor of Law from the University of Michigan, a very special institution that's very much appreciated around this table, especially by the chairman here.

Why don't we start with you. I'm going to ask each of you, if you can—I realize this is complicated material—to try to summarize your comments as much as you can in roughly a 5-minute period, and then if you find that you need a little bit more time than that we'll try to be flexible. But if you can do that, we will make your entire statement a part of the record.

STATEMENT OF DONALD C. LANGEVOORT, VISITING PROFESSOR OF LAW, MICHIGAN UNIVERSITY

Mr. LANGEVOORT. Thank you, Mr. Chairman.

I am pleased to have this opportunity to be here today to testify on S. 1380 and the legislative proposal submitted by the Securities and Exchange Commission. Let me express my strong support, with a few minor reservations only, for the reconciliation draft arrived at by the Commission and the ad hoc committee.

In my view, the case for legislative reform in the area of insider trading is absolutely compelling. To date, the prevailing legal structure has been workable, but no more than that. The fact that so many recent cases have been settled rather than litigated disguises how many open questions remain about the law, questions that if ever resolved against the SEC or Federal prosecutors would create serious gaps in the enforcement scheme.

At a time when volatility and technological change are independently creating such stress in the securities marketplace, any restriction of the effectiveness of the enforcement program in terms

of assuring a basic level of fairness could have the most unfortunate consequences.

As I said, I do have a few specific suggestions for clarifications to the proposal in order to better carry out the subcommittee's stated intent of strengthening the insider trading prohibition.

For example, I support the provision to adopt a wrongfulness standard for insider trading liability, but I am concerned by the exclusive definition of wrongfulness which speaks in terms of theft or breach of duty as a basis for liability.

Questions of whether a relationship or trust or confidence exists or whether it has been breached has troubled courts throughout the history of American law, evoking little consistency or coherence. If applied narrowly by the courts, the standard now in the bill could leave a considerable number of instances of abusive trading unreachable under the new statute.

It seems to me that insider trading should be prohibited not because the trader has violated some separate duty of loyalty to someone, something that has historically been the province of State law in any event, but because it undermines the integrity of the marketplace for a person to take advantage of information that is meant to be confidential.

I have indicated in my written statement a number of ways that the definition could appropriately be broadened.

This one concern notwithstanding, I wish to emphasize my strong support for the legislation currently before this subcommittee. With the minor clarifications I've suggested, I believe that the enactment of the November 18 reconciliation draft would be an exemplary response to the problems that remain in the area of insider trading.

Thank you.

[The complete prepared statement of Donald C. Langevoort follows:]

STATEMENT OF DONALD C. LANGEVOORT, ASSOCIATE PROFESSOR OF LAW, VANDERBILT UNIVERSITY, AND VISITING PROFESSOR OF LAW, UNIVERSITY OF MICHIGAN, ON S. 1380 AND ASSOCIATED LEGISLATIVE PROPOSALS

December 15, 1987

I am pleased to have this opportunity to testify on S. 1380, the Insider Trading Proscriptions Act of 1987, as well as on the legislative proposal made to this Subcommittee by the Securities and Exchange Commission in its letter dated November 18, 1987 (which modifies the Commission's previous proposal of August 3, 1987). In my view, the case for legislative reform in the area of insider trading is compelling. While I do have specific suggestions for changes in order better to carry out the Subcommittee's stated intent of strengthening the insider trading prohibition, I should emphasize at the outset that even as currently drafted, either of these proposals would represent considerable improvement over the existing state of the law.

I. *The Need for Legislation*

There is a vigorous debate in the academic community as to the propriety of prohibiting insider trading. Critics of the restriction argue that insider trading is a means of promoting allocational efficiency by promptly incorporating new information into the securities marketplace, especially when the class of potential traders is broadened to include those (e.g., investment analysts) who receive information from company sources.

This argument, however, seriously understates the principal reason why a prohibition is necessary: the need to provide a basic level of confidence that a degree of fundamental fairness governs the transactions that occur among investors in the securities marketplace. This objective was clearly stated in the debates that preceded the enactment of the Securities Act of 1933 and the Securities Exchange Act of 1934 -- leading to the enactment of section 16(b) of the latter statute -- and was strongly reemphasized in the legislative history of the Insider Trading Sanctions Act of 1984. I am aware of no evidence that suggests an abandonment of the historic legislative commitment to this goal would be without serious consequence in terms of the proper functioning of the capital markets, particularly at a time when

volatility and technological change in the markets are independently creating such stress in this area.

Moreover, there are other important objectives that are served by a ban on insider trading. An insider trading prohibition is essential to secure another major goal of securities regulation, the prompt public disclosure of material corporate developments. Absent such prohibition, there is a serious disincentive for insiders to make full disclosure at the earliest practical point in time Finally, insider trading profits to corporate managers and their associates represent a secret undisclosed form of compensation from their position another result contrary to the basic intent of federal securities regulation.

Given this, the important question becomes how successful the prevailing legal structure is at dealing with insider trading problems. To date, this structure has been workable, but little more than that. The fact that most recent cases have been settled, rather than litigated, disguises how many open questions remain about the law, questions that if ever resolved against the SEC or federal prosecutors would create serious gaps in the enforcement scheme.

A comprehensive list of such open questions is beyond the scope of this testimony. The following is a brief survey of some of the most notable "hard" issues While arguments may be made either way, there is some indication in current law that liability might *not* attach in each of these situations:

> -- *Who is an insider?* What would happen if a company is engaged in confidential merger negotiations with another, thereby learning material nonpublic information, and then negotiations then break off? Is the first company free to trade or tip?[1] Or what of the situation where a company repurchases its own shares while in possession of material nonpublic information? Or an insider who trades in corporate bonds or debentures?
>
> -- *Tipping Liability*. What is meant by the "personal benefit" standard created by the Supreme Court in the *Dirks* case? Is there liability if a company executive gives an

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1 In *Walton v. Morgan Stanley Inc.*, 623 F.2d 796 (2d Cir. 1980), a state common law case invoking principles similar to those used under rule 10b-5, the court found no liability under such circumstances.

investment analyst clearly material information in order to reward him for favorable recommendations made about the company in the past? What of tippees who in turn tip others: how is the second-level tippee's liability (if any) to be addressed?

-- *Misappropriation*. When persons with access to information from their employer or client trade in the shares of *other* companies, are they liable at all? After the Supreme Court's recent *Carpenter* decision, the issue is clouded. Even if the theory remains, will a defendant prevail if he or she can show that the employer did not affirmatively wish to preclude the trading?

-- *Rule 14e-3*. Is this rule, the lynchpin in combatting tender offer trading abuses, a valid exercise of administrative authority in light of the Supreme Court's insistence on a test under section 10(b) that requires some showing of breach of duty?

Each of these questions is difficult largely because it must be analyzed as a *fraud* question, under the artificial doctrine built by the Court in *Chiarella* and *Dirks*. In fact, it is probably a fiction to think of insider trading as deceptive in the first place. The resulting doctrinal framework simply reflects this awkwardness. Unfortunately, the framework is now such that some instances of abusive trading may not be reachable. In light of the uneasy basis for the prohibition, the case for legislation strengthening the prevailing framework by establishing a separate, coherent statutory insider trading prohibition is surely compelling.

II. *S. 1380*.

S. 1380 offers a statutory framework, divorced from the requirement of establishing fraud, that would resolve in a satisfactory fashion many of the open questions described above. In this respect, even as currently drafted, it would represent a step forward in the law.

Nonetheless, there are certain changes and clarifications to the bill that would seem appropriate in order to strengthen its prohibitions. While I would prefer that these be in the nature of changes to the language of the provisions themselves, most could be done acceptably via legislative history as well.

A. *"Wrongfully."* The centerpiece of the restriction on insider trading in S. 1380 is the requirement that information be obtained or used "wrongfully," which in turn is defined in terms of "theft, conversion, misappropriation or a breach of any fiduciary, contractual, employment, personal or other relationship of trust and confidence." This seems to be unnecessarily vague and complicated, forcing a court to consider a breach of duty question without any point of reference to the source of the duty. Is it a matter of state common law?[2] If so, why, given the federal nature of the prohibition? The breach of duty standard exists in the law today only because the Supreme Court found it necessary in the *Chiarella* case to find a basis for the affirmative duty of disclosure under section 10(b). Under new legislation, such restrictive reasoning is unnecessary. Complicating the liability question by imposing an independent, pre-existing duty standard serves no point except to encourage defendants to argue that their abusive trading as a technical matter violated no state law duty of loyalty, or that it was tacitly approved by their superiors in the organization. As a result of its ambiguity, some of the difficult open questions noted above (e.g., trading by the issuer itself, or by a company that was negotiating a merger) would remain even after adoption of this standard.

It seems to me that insider trading ought be prohibited not because the trader has violated some separate duty of loyalty to someone -- which is largely the concern of state law -- but because it undermines the integrity of the marketplace to take advantage of information that comes from any of a variety of sources having a regular nexus to the securities marketplace when that information is intended to be confidential. There are at least three ways that the bill could be amended to reflect this approach. First, the language could be based on that found in rule 14e-3, which contains no such duty standard, and has worked very well. Alternatively, the legislation could impose a duty not to trade while in possession of information on persons who have a "position of access" with respect to certain specified sources of

[2] In this regard, it is important to note that some states do *not* view insider trading by corporate insiders as a breach of duty under state corporation law. *See Schein v. Chasen*, 313 So. 2d 739 (Fla. 1975); *Freeman v. Decio*, 584 F.2d 186 (7th Cir. 1978)(Indiana law).

information.[3] A position of access would be defined as a relationship that would reasonably be expected to give the person in question access to material nonpublic information relating to securities, and where it would be reasonable to expect such person not to disclose the information except in the performance of his stated functions. This approach is similar to that adopted by Great Britain in the Company Securities (Insider Dealings) Act of 1985 (L. Rep. Stat. ch. 8). A third possibility for curing this difficulty would be to retain the wrongfulness standard, but to make its definition in terms of theft or breach of duty non-exclusive.

However this issue is resolved, the bill should make clear, as it does not presently, that the concept of wrongful use includes trading by the issuer of the securities itself while in possession of material nonpublic information.

B. *Motivation.* As the SEC has indicated in its proposals, a "possession" (rather than S. 1380's "influenced") standard provides a more effective deterrent to insider trading, especially as applied to persons (like investment analysts) whose decisions are arguably influenced by various sorts of information. concur with the Commission's view.

C. *Tippee Liability.* S. 1380 seems to intend that tippee liability -- which realistically does not involve a breach of any direct or independent duty owed to anyone by the tippee -- is precluded because it represents an "indirect" (i.e., derivative) breach of the insider's duty. This conclusion seems needlessly vague in the legislation, and the standard is potentially subject to difficulties in its application, especially as to remote tippees. A much simpler approach would be to add a sentence or subparagraph to the anti-tipping section ((c)(1)) to provide that a tippee must refrain from trading if he knows or is reckless in not knowing that the information was directly or indirectly communicated in violation of that subsection.

[3] Such a list of sources, enumerated in the Commission's August draft, would include (1) the issuer, (2) government agencies and courts, and (3) registered investment professionals, e.g., broker-dealers, investment companies or advisers, or self-regulatory organizations. In addition, it might be advisable to include in such a list any person or entity about to take action that would reasonably be expected to affect the market price of the issuer's securities.

D. ***Private Rights of Action.*** **As the SEC has** recommended, the section on private rights should provide that the limitation of the amount of profits does not apply when the action is brought by persons other than marketplace traders, e.g., companies whose acquisition plans were harmed by insider trading. In addition, the "contemporaneous" trader standard, though borrowed from current law, seems both ambiguous and an unnecessarily restrictive remnant of the fraud basis for insider trading liability. A person who traded three weeks after the insider should not be precluded from the plaintiff class if the information in question was no more publicly available then as the day the insider traded. A clearer standard would be to define the appropriate plaintiff class as all those who traded from the time the defendant traded to the date of effective public disclosure of the information in question -- the same standard used to define profits in the civil penalty provision of the Insider Trading Sanctions Act of 1984.

III. *The November 18 Proposal.*

The November 18 proposal by the SEC, a compromise draft reflecting agreement with the Ad Hoc Legislative Committee that produced S. 1380, makes a number of improvements in relation both to the original bill and the Commission's draft legislation of August 3, 1987. The problems noted above with respect to the motivation question and the exclusivity of the private right of action standard are corrected. Although some of the other concerns expressed above with respect to S. 1380 remain, I strongly endorse this new version as the best of the three proposals that have formally been submitted to the Subcommittee. The remaining concerns are the following:

A. *"Wrongfully."* The November 18 draft retains the same wrongfulness concept -- tied to the same unidentified source of the duty not to trade -- as S. 1380. Thus, the same reservations and recommendations made above apply here as well.

B. *Tippee Liability.* The draft contains the same vagueness and uncertainty with respect to tippee liability as S. 1380. Again, the same reservations and recommendations made above apply here.

C. *Private Rights.* The concern about the contemporaneousness standard remains; it might be changed along the lines suggested above.

D. ***Suggestion for Legislative History.***

In the letter accompanying the consensus draft, the Commission suggests a number of clarifications that it believes should appear in the legislative history of the bill. Two of these deserve some comment:

1. *The Import of "Misappropriation" and "Conversion* The Commission recommends that these terms be described in the legislative history as referring to pre-existing duties, waiveable by consent. As noted above, it seems wrong to characterize the federal duty to refrain from insider trading as turning on state law breaches of fiduciary obligation; rather, the proper test is one that prohibits those with access to information from sources with a regular nexus to the securities markets that is intended to be nonpublic from tipping or trading while in possession of that information.

2. *The Application of the Bill to Communications Leading to Public Disclosure.* The Commission properly notes the importance of communications leading to public disclosure, particularly communications to investment analysts, in the disclosure process. Nothing in the bill should unduly chill such communications. At the same time, however, it should be made clear that the fact that one is an investment analyst does not provide a right to trade for client accounts on information that was clearly "tipped" by insiders. In the Commission's August draft, a safe-harbor exclusion was created for trading through analyst recommendations unless the information was communicated for the "personal benefit" of a company insider. This standard would have left a troublesome loophole in the law, in the case where a company executive tipped information to an analyst to reward him or her for past favorable recommendations, so as to encourage similar enthusiasm in the future.[4] Such communications presumably would not be for the personal benefit of the insider, but they are nonetheless blatant tips. Permitting such communications raises the possibility of companies seeking to "buy" the favor of analysts using the currency of inside information, creating serious conflicts of interest that would threaten the integrity of the entire process of

[4] This factual situation was essentially that in *Elkind v. Liggett & Myers Inc.*, 635 F.2d 156 (2d Cir. 1980); see also, *SEC v. Lum's*, 365 F. Supp. 1046 (S.D.N.Y. 1973). Although liability was imposed in both these cases, *Dirks* casts a cloud over these holdings under current law. The Commission's August draft would apparently have reversed these results.

investment intermediation. Happily, this safe harbor is now gone from the proposal. The legislative history accompanying the bill should make clear that precisely the opposite result is intended: although innocent, good faith communications to analysts and reporters should not lead to insider liability, abject tips -- whatever their motivation -- should be unlawful.

IV. *Conclusion.*

I strongly support the effort of the Subcommittee to develop insider trading legislation along the lines found in S. 1380 and the SEC's November 18 proposal. Even without the changes that I have suggested, they would both represent considerable improvements in the law. With certain minor clarifications in language or legislative history, enactment of the November 18 proposal would be an exemplary response to the legal problems that remain in the area of insider trading.

Senator RIEGLE. Thank you. We're glad to have your endorsement and your suggestions as well.

Mr. Bialkin, we're pleased to have you here today.

STATEMENT OF KENNETH J. BIALKIN, OF THE NEW YORK BAR

Mr. BIALKIN. Thank you, Mr. Chairman.

I have submitted a statement and so I will only briefly summarize the salient points.

My statement recites that I am accompanied by Richard B. Smith, former Commissioner of the SEC, since we thought initially this would be a sole testimony; but it's a panel and so former Commissioner Smith isn't here.

I am testifying as an individual today. I want to make that very plain. However, I want to share with you my other status. That is to say, I am chairman of the ad hoc committee of the Section of Corporation Banking and Business Law of the American Bar Association to consider insider trading legislation. That committee was appointed in order to try to sort through the various bills that have been proposed and various variations of those bills that have been proposed by the subcommittee, by the SEC, by the New York Stock Exchange Legal Advisory Committee, and to try to be constructive in it.

The members of that committee, eleven of them, are drawn from all sectors of the bar. Two of them include Harvey Pitt and John Olson, who have been consultants to this subcommittee. Al Sommer, a former SEC Commissioner and former chairman of our section; Dick Smith, a former SEC Commissioner; Dick Phillips, a former chairman of the ABA's Securities Law Committee and chairman of the Drafting Committee of the New York Stock Exchange Legal Advisory Committee; Jim Cheek, who is the present chairman of the ABA Securities Law Committee; Tom Baker, who is an officer of the section; Louis Loss, who is the dean of securities law in the United States; Milton Freeman, who is generally regarded as the person who drafted rule 10(b)(5), and Martin Lipton, a highly respected securities lawyer.

As I say, our committee has really a very broad base of experience and knowledge in the field.

We have established an informal consensus which is not the official position of either the section or the ABA, for the reason that there simply hasn't been time within the framework of the availability of the drafts to reflect that through the processes of the ABA, and so I cannot suggest that what I am about to say has the support of the section or the ABA.

It doesn't even have the support of all the committee members. Of the eleven members, eight have more or less established the consensus. Two, Messrs. Pitt and Olson, have filed a separate statement included with mine. One, Al Sommer, has also filed a separate statement. They would disagree with the consensus.

SUGGESTIONS FOR IMPROVEMENT OF THE BILL

But to the extent that there is a consensus by the remaining eight out of the eleven. Our feeling is, notwithstanding our very strong antipathy to insider trading and very strong feeling that

none can condone it, and what has happened is properly something that has to be condemned, that the bills—when I refer to the bills, I mean the SEC bill transmitted to you on November 18 and what I refer to as the reconciliation bill is a subsequent iteration of S. 1380 amended to try to meld the differences between the SEC bill and S. 1380—we feel that, on balance and in light of the fact that Winans was affirmed and not reversed, that unless the bills can be corrected in several of the ways that we have suggested that they be corrected, that it would be better not to adopt the bills than to adopt the bills in a fashion that would continue some of the problems that we think are present in the bill. Although I'm not totally familiar with the testimony in detail of the SIA, some of the points they have made concerning the status of research analysts and the status of firms and the status of Chinese walls give us a problem as well because of the presumptions and burdens of proof aspect of those issues. That is, there is no presumption of a safe harbor and there is no presumption that Chinese walls, systems and procedures are adequate.

Quite to the contrary, it's the burden of proof on the institution to show that there was no improper profiting from the issue. It's the "profits from" words in the statute that give us a considerable amount of difficulty. We would suggest that if you deleted those words, the statute would be substantially improved.

We have many other suggestions for substantial improvement of the bill. We hope you would look at them. I know Chairman Ruder responded to your question about materiality, Mr. Chairman. We feel that in an area of insider trading, materiality which we would define as information likely to have a substantial impact in the market price of a security, isn't that hard to understand. There is no definition of materiality in the securities law today. The *Northway* case suggests that it's a mix of information which would be regarded as important in certain circumstances.

We think for something as important as this and as expansive as this, it's not too much that people know what it is they are talking about.

We think the bill extends the scope of insider trading liability beyond that which might be regarded today as even within the *Winans* case because, as defined, the bills cover market information. Traditionally and historically, inside information has been limited to information pertaining to the status of a particular issuer—the issuer of securities. The definition both in the reconciliation bill and the SEC bill would relate the inside information to securities or to the market for the securities, thereby opening up a Pandora's box of potential exposure to insider trading having nothing necessarily to do with the inherent information relative to a security, the sole exception being the tender offer area which we do think should be preserved the way it is under rule 13(e)(3) and is transported into your bill.

But we think, that without analysis and without discussion of what the implications of covering market information, as contrasted to issuer information—without discussion and without analysis and without hypotheticals—and I could give you some that would frighten you considerably—we think it's too far to go.

The private action, which we do not disagree with, is drafted in a way that leads us to great confusion as to what it means, how far it goes, how does it rest vis-a-vis the existing standards of rule 10(b)(5)? The notion of exclusivity—does it deprive some people of action today who might have it, does it add something? If so, what? What are the elements of a cause of action in the (b) section as opposed to the first section? The addition of liability for contemporaneous traders limited to the damages earned by the insider trader, may be an illusory remedy. If a trader trades and makes a relatively small profit and contemporaneous traders out there have lost a great deal of money, the total recovery for all the contemporaneous traders is limited by the amount of profit of the individual trader. That may be a miniscule fraction of what the contemporaneous traders have lost. It produces litigation. There is no clarification as to how they wind up, are they class actions, how you divide the money, who does it go to or where does it go?

This liability for the insider trader is on top of the treble damage or the treble measure provided by the Insider Trading Sanctions Act of last year, exclusive of the disgorgement provisions, exclusive of the criminal aspects already available under the Winans authority. We wonder whether it's an illusory remedy and whether the provisions for the additional cause of action—I'm sorry if I'm speaking fast but I wanted to get the points through—whether or not it really ought not to be rethought in terms of exclusivity.

EXCLUSIVITY

Exclusivity is mentioned as desirable in the findings. We don't know what that means. We've discussed among ourselves as to exclusive as to what, what does it mean, what causes of action does it provoke, what causes of action does it add? We don't know what you mean by exclusivity, which is not even part of a statute. It's part of the recital of findings.

We have a certain problem with the SEC in their letter to you who suggest that a lot of these problems be fixed by stating what the legislative history is. When you're starting clean with a new statute that a Senate Subcommittee is considering, and when issues are before you, it seems to us that the plain meaning of the statute ought to cover all those points that are confusing and not to rely on the ambiguity of a legislative history which is going to be the subject of a very great disagreement in the future.

So we think simply as a legislative technique in addressing issues, to say, well, we will resolve these problems by giving some recital of legislative history. When you know what the problems are and when you can fix them by the simple medium of sitting down around a table, discussing them and drawing words to say what it is you mean and mean what it is you say, you should do so. Any other way is a poor way, with great respect, of providing for the law of the land.

I will yield my time. I saw the red light there for some time and I appreciate your indulgence.

[The complete prepared statement of Kenneth J. Bialkin follows:]

TESTIMONY OF KENNETH J. BIALKIN, ESQ.

December 15, 1987

HEARINGS ON S.1380, 100th CONGRESS FIRST SESSION, SECURITIES SUBCOMMITTEE, COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS, UNITED STATES SENATE HONORABLE DONALD W. RIEGLE, JR. CHAIRMAN

Chairman Riegle and Honorable Members of the Subcommittee: My name is Kenneth J. Bialkin, a member of the New York Bar.[1] I am accompanied this morning by Richard B. Smith, Esq. of the New York Bar.[2] I appear before you this morning as an individual and the views I will present today are my own and do not necessarily represent those of my firm or its clients. As I believe you know, I am also Chairman of the Ad Hoc Committee to Consider Insider Trading Legislation (the "Committee"), appointed last summer by Robert L. Berner, Jr., Chairman of the Section of Corporation, Banking and Business Law of the American Bar Association. The Section is the largest section of the American Bar Association, with over 50,000 lawyers representing a broad cross section of the American corporate and business bar. Our Committee was appointed last summer following the introduction of S.1380 and the announcement of proposed statutory alternatives regarding insider trading by the Securities and Exchange Commission (the "SEC") and the Legal Advisory Committee of the New York Stock Exchange (the "NYSE Legal Advisory Committee"). The mandate of the Committee was to review the proposed legislation in an effort to assist the American Bar Association in developing its position with regard to the issues posed by the proposed insider trading legislation.

I will describe below the activities of the Committee to date with respect to analysing the proposed legislation, but I want to make clear that I am presenting my testimony as an individual and not as the Committee's testimony for two reasons. First, the views I will express are not unanimously shared by all the members of the Committee, although as I will explain, our considerations to date have led to what I believe is a developing consensus in a number of areas. Second, and more importantly, because of the time constraints involved in trying to respond to Chairman Riegle's request that I appear today, it has not been possible for me to formally seek the approval required of the Section of Corporation, Banking and Business Law or of the American Bar Association more generally to present this testimony on their behalf. That approval process simply takes more time than was available before the hearing scheduled for today. I do believe, however, that it will be useful to the Senate Banking Committee's consideration of the proposed legislation for me to describe what the thinking of the consensus of the members of the Committee appears to be to date and the process by which those views were formulated. Nevertheless, as already noted, I do not purport to speak for the Committee, the Section of Corporation, Banking and Business Law or the American Bar Association. Our Committee intends to continue its study and analysis of the proposed insider trading legislation and there may come a time in the future when, after the necessary approval process has been completed, the Committee and the Section will be in a position to formally state their views.

For the time being, however, you should understand that when I refer to the consensus views of the Committee, those views have not yet received formal American Bar

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1 Mr. Bialkin is a partner in the New York law firm of Willkie Farr & Gallagher. From 1968 until recently, he has taught Federal Regulation of Securities at New York University Law School, where he is Adjunct Professor of Law. He is former Chairman of the Section of Corporation, Banking and Business Law and the Committee on Federal Regulation of Securities of the American Bar Association. He has lectured and written extensively in the fields of corporation finance and securities regulation. Mr. Bialkin is a graduate of the University of Michigan and of Harvard Law School. He is a director of several corporations. Also, he is a member of the Board of Directors of The Municipal Assistance Corporation for the City of New York. He has served as an advisor to the Federal Securities Code Project of the American Law Institute and to the Corporate Governance Project of the ALI, as well as on advisory committees of the Securities and Exchange Commission, the New York Stock Exchange and the American Stock Exchange. Mr. Bialkin is currently President of the New York County Lawyers' Association.

2 Mr. Smith, a member of the law firm of Davis, Polk & Wardwell, is a securities law practitioner and is a former Commissioner of the United States Securities & Exchange Commission. He has written and lectured widely on securities and corporate law and is a member of the Ad Hoc Committee to Consider Insider Trading Legislation referred to herein. He has served as an advisor to the Federal Securities Code Project of the American Law Institute and to the Corporate Governance Project of the Institute.

Association approval and cannot be said to be unanimous in light of vigorous dissents expressed by two of the Committee's members.[3]

The members of the Committee[4] are each experienced securities lawyers with many years of active practice. The Committee includes two of the lawyers who advised the Securities Subcommittee with respect to S.1380 as a part of the Ad Hoc Lawyers' Committee invited to participate by Chairman Riegle. Our Committee also includes the Chairman of the Subcommittee on Tender Offers of the NYSE Legal Advisory Committee which drafted a legislative proposal on the insider trading problem.

Following their appointment, the members of the Committee met four times to consider the evolving proposals for

3 More specifically, unless otherwise noted, the comments and recommendations in my testimony are joined in by Messrs. Baker, Cheek, Freeman, Lipton, Phillips and Smith. Professor Louis Loss concurs in this statement to the extent of considering that the criticisms raise serious questions that should be studied further by Congress and the SEC. Messrs. Pitt and Olson dissent from the views I am expressing and their separate statement is attached to this testimony.

4 The membership of the Committee is as follows: Kenneth J. Bialkin, Esq. (Chairman) Thomas E. Baker, Esq., Shell Oil Company; James H. Cheek, III, Esq. member of the law firm of Bass, Berry & Sims; Milton V. Freeman, Esq., member of the law firm of Arnold & Porter; Martin Lipton, Esq., member of the law firm of Wachtell, Lipton, Rosen & Katz; Louis Loss, Esq. of the Harvard Law School; John F. Olson, Esq., member of the law firm of Gibson Dunn & Crutcher; Richard M. Phillips, Esq., member of the law firm of Kirkpatrick and Lockhart; Harvey L. Pitt, Esq., member of the law firm of Fried, Frank, Harris, Shriver & Jacobson; Richard B. Smith, Esq.; and A. A. Sommer, Jr., Esq., member of the law firm of Morgan Lewis & Bockius. The Committee was assisted in its work by Jeanne M. Luboja, Steven J. Gartner and Ziporah Janowski of Willkie Farr & Gallagher. Certain Committee members were also assisted by colleagues from their law firms as follows: Mr. Lipton was assisted by Robert A. Ragazzo, Esq.; Mr. Pitt was assisted by Karen L. Shapiro, Esq.; Mr. Phillips was assisted by Larry R. Lavoie, Esq.; and Mr. Olson was assisted by Jordan D. Hershman and Thomas H. Pennington, Esqs.

legislation with respect to insider trading and to prepare the Committee's recommendations with respect to the legislation ultimately proposed by the SEC on or about November 18, 1987 (the "SEC Bill") and the Reconciliation Draft of S.1380 proposed by the group working with Harvey Pitt on or about November 19, 1987 (the "Reconciliation Draft"). Between formal Committee meetings, the Committee members reviewed the extensive background information concerning the evolving versions of the SEC Bill and the Reconciliation Draft which had been prepared by their authors as well as the definition proposed by the NYSE Legal Advisory Committee and other material concerning regulation of insider trading. Committee members also prepared and exchanged written commentaries on various aspects of the proposed legislation and alternative draft language designed to address some of the concerns which certain Committee members raised about various aspects of the proposed bills.

Before expressing the views of the consensus of the Committee to date, however, I do want to emphasize that all of its members were in total agreement as to our shared belief that insider trading is to be abhorred because it runs contrary to American notions of fair play and shakes the confidence of the investing public in our nation's securities markets. There can be no justification for the rash of insider trading violations which have recently been revealed and we applaud the efforts of the members of this Subcommittee and others in the Congress who have moved forcefully to focus attention on the question of what can be done to prevent such violations in the future. Our Committee's effort has been to consider whether the current proposals reflected in the SEC Bill and the Reconciliation Draft are the best way to address the insider trading problem, and, as my testimony continues, it will become apparent that the consensus of the Committee is that these bills may not be the best solution.

The most recent drafts of the SEC Bill and the Reconciliation Draft have not been available for review by the Committee for as long a period of time as would have been desirable. The Committee, therefore, has not attempted to formulate a detailed analysis of every aspect of the draft language in each of the pending proposals, but has concentrated instead on a number of key areas of concern.

The Committee has concluded that, while there should be significant benefits which would stem from appropriate legislation designed at least to clarify and possibly improve the existing state of the law on insider trading, the current SEC Bill and Reconciliation Draft do not clarify or address a number of important issues in a way which the Committee

believes will set insider trading law on an appropriate course for the future. We regard both the SEC Bill and the Reconciliation Draft as presenting such problems and questions that unless they can be modified as suggested in this testimony, we would oppose their adoption. Our general views as to the nature of appropriate legislation might be different if the Supreme Court in Carpenter, et al. v. United States had not affirmed the judgment of the United States Court of Appeals for the Second Circuit. The affirmance of the mail and wire fraud convictions in that case, explained in the Supreme Court opinion, and the affirmance by an evenly divided court of the judgment of the Second Circuit with regard to the securities law issues, provides the SEC and other law enforcement agencies of the United States with powerful weapons in the continuing fight against insider trading abuses. Even if Carpenter had not been affirmed, however, serious questions would remain about the proposed bills.

We recognize that the Supreme Court has not expressed itself regarding the application of the so-called misappropriation theory under the Securities Exchange Act of 1934, but those issues remain the law in the Second Circuit, and elsewhere, and have been adopted and advocated by the SEC as its official attitude and policy regarding its enforcement activities and responsiblities. We also recognize that while it might be suggested that legislation is desirable to clarify issues regarding the application of the securities laws to the misappropriation theory, that would be true only if the proposed legislation did not contain provisions which we believe go further than is necessary or desirable in the proper continuance of the struggle against insider trading abuses. The Committee, therefore, opposes the passage of insider trading legislation in the format provided for by the SEC Bill and the Reconciliation Draft.[5] The Committee also believes, however, that appropriate insider trading legislation which would warrant the support of the Committee and the American Bar Association could be developed by following a legislative approach which would take into account and resolve the central

5 While certain differences remain between the SEC Bill and the Reconciliation Draft, the Committee believes that, in general, its comments and recommendations apply equally to the two proposals. The SEC Bill and the Reconciliation Draft are therefore treated jointly in this testimony, except where otherwise specified and are referred to jointly as the "bills."

problems with the existing proposals which are detailed below.[6]

I shall now try to summarize the particular substantive objections and suggestions which we have with regard to the proposed legislation and our suggestions for amendment and modification which would meet these objections.

A. Definition of "Material" Information

Neither the SEC Bill nor the Reconciliation Draft defines the "materiality" standard to be applied under the legislation.[7] The Committee believes that materiality is a fundamental concept which should be defined in any insider trading legislation which may be adopted.

With respect to defining the standard of "materiality" to be applied, the Committee believes that it would be appropriate to adopt a standard which would require that the

6 Our analysis of the bills was assisted by a memorandum dated December 1, 1987 prepared by Richard M. Phillips, Esq. and Larry R. Lavoie, Esq. with respect to the SEC's latest revised bill. Mr. Phillips is Chairman of the Subcommittee on Tender Offers of the NYSE Legal Advisory Committee

7 Several Committee members also feel that legislation prohibiting misuse of non-public information should not be adopted without attempting to provide a definition of what "non-public information" includes. One approach to defining "non-public information" which was suggested to the Committee during the Committee's deliberations and which draws on a provision of the American Law Institute's Federal Securities Code, would resolve this issue by providing as follows:

> "Non-public information means information that is not generally available. Information that has been disclosed for more than one full business day (or any other period prescribed by Commission rule) by means of a filing with the Commission or press release or any other manner reasonably designed to bring the information to the attention of the investing public shall be deemed to be generally available. Otherwise the burden of proving that information is generally available shall be on the person who so asserts."

information, if made publicly available, would have a substantial impact on the price of the stock at issue or a variation on this market impact approach such as that utilized in the definition of a "fact of special significance" found in the American Law Institute's Federal Securities Code.[8] The Committee believes that such a definition would be more appropriate in the context of legislation providing for broad proscriptions with respect to insider trading than use of the lower threshold definition of materiality utilized in the TSC v. Northway case which courts have used to test the materiality of information to be included in or omitted from proxy and registration statements but which provides little guidance in the context of secondary market transactions.

B. Coverage of "Market Information"

The Committee believes both the SEC Bill and the Reconciliation Draft move too far away from coverage of only traditional issuer-related insider information in apparently providing for coverage of the full spectrum of information which can be characterized as "market information".[9] The Committee believes that such an approach goes too far and risks chilling the free exchange of information which is central to the efficient operation of the nation's securities markets. We agree that it may be necessary to specifically extend coverage to a limited number of uses of information which do not fit within traditional notions of issuer-related insider information such as in a Carpenter-like case or the tender

8 Federal Securities Code § 202(56) (1980). "A fact is 'of special significance' if (A) in addition to being material it would be likely on being made generally available to affect the market price of a security to a significant extent, or (B) a reasonable person would consider it especially important under the circumstances in determining his course of action in the light of such factors as the degree of its specificity, the extent of its difference from information generally available previously, and its nature and reliability." The ALI's Federal Securities Code, which resulted from ten years of intensive work by a preeminent Reporter, Consultants and Advisory Committee, received the SEC's full approval and support. SEC Release No. 33-6242 (September 18, 1980).

9 Mr. Phillips and Mr. Baker dissent with respect to this aspect of the Committee's recommendations. They support legislation which would cover market information so long as such information was stolen, misappropriated or otherwise wrongfully obtained or used.

offer area. The Committee would favor legislation that would provide workable prohibitions against the misuse of information relating to tender offers. However, the unlimited extension of the bills' proscriptions to all market information is not a manageable solution. The existing law regarding market information as a basis for liability under the securities laws is not as clear or as well developed as some observers suggest and before legislation on that subject is enacted, further study and review is necessary.

C. Limitation on Derivative Liability

While the Committee believes that the bills seek to limit derivative liability in a useful way by providing for respondeat superior liability only under limited circumstances, at least one of the exceptions is unclear. The Reconciliation Draft would provide that, except as provided in Section 20(a) of the Securities Exchange Act of 1934 which deals with controlling person liability, a person could not be held liable for an insider trading violation "solely by reason of the fact that such person controls or employs a person who has violated this section, if such controlling person or employer did not participate in, profit from, or directly or indirectly induce the acts constituting the violation ... ."[10] This would in some respects (1) restate the case law on controlling person liability as developed under Section 20(a) and (2) exclude common law respondeat superior liability for insider trading cases. The bills provide, however, that respondeat superior liability will be available in situations where an employer "profits" from the misuse of insider information by an employee. To the extent this provision imposes respondeat superior liability on an employer who unknowingly and unintentionally profits from its employee's violation, the exception appears to be too broad. There is no need to create liability for employers who innocently profit from their employee's illegal trading. Similarly, since the nature of any "profit" is undefined, extremely indirect benefits to an employer may be alleged and succeed in imposing strict liability on an employer for an insider trader's actions. The "profits from" language could be construed broadly to reach all forms of tangible or intangible benefits flowing from an employee's violation. If this is so, creative plaintiffs' lawyers will be able to make an argument in virtually any case that the firm somehow benefitted from the employee's misconduct. Indeed, a mere reputational benefit, which could translate into future earnings for the firm, might be

10 Proposed Section 16A(d).

sufficient to constitute profits obtained within the meaning of the statute.

The firm's liability could also be wholly disproportionate to any purported "profit" it received from the employee's misconduct. Under the Reconciliation Draft's approach there is no cap on potential liability except in actions by contemporaneous traders. Thus, it would be possible for a firm that profited by $100 in commissions to be held liable for $1 million in damages caused by an employee's insider trading violation. It is questionable whether such liability might be appropriate even if the employer firm was culpable in some sense. However, there can be no justification for the "profits from" language which exposes an employer to potential liability even if the employer takes appropriate steps to prevent misconduct. We suggest deletion of the "profits from" language.

D. "Exclusivity" of the Legislation

Although recital 16A(a)(5) addresses the "exclusivity" of the prohibitions provided for by proposed Section 16A, the scope and thrust of this "exclusivity" are not entirely clear. For example, what is left of classic Rule 10b-5 law and the insider trading theories that have been developed under it? Some of those familiar with the drafting of the exclusivity provision have suggested that the intention is to make Section 16A the exclusive remedy under the federal securities laws for insider trading violations, but without interfering with the ability to continue to assert different causes of action if other provisions of the federal securities laws (such as Section 9(a) of the Securities Exchange Act of 1934 which prohibits market manipulation) were simultaneously violated. If this is the intent, it should be clearly spelled out as well as whether violations of other laws (for example, mail and wire fraud) based on misuse of material non-public information may still be asserted.

E. Limitations of Affirmative Defenses in Section 16A(b)(2)

In the context of "possession" rather than "use" statutes which both the SEC Bill and the Reconciliation Draft have now become, the Committee believes that an affirmative defense should be available to a natural person who believes he can prove that, although he was technically "in possession" of inside information (what constitutes "possession" is not defined in the bills), he did not utilize such information in deciding to trade.

The Bills offer an individual no opportunity to prove that he or she did not trade on the basis of material, non-public information that is in his or her "possession." There are, of course, numerous situations which happen every day in which a person might purchase or sell stock while in possession of material, non-public information, and, yet, his transaction would not be based on the information.

The purchase of stock by a corporate officer pursuant to an automatic dividend reinvestment plan becomes a criminal act under a possession standard if the officer has "possession" of any "material," "non-public" information about the officer's company. The purchase of stock by an officer's broker in a discretionary account, without direction from the officer, might also be alleged to be unlawful if the officer had possession of material, non-public information. The possession standard is also troublesome for corporate officers and directors because it is a vague, undefined concept. For example, a corporate officer may be considered to be in possession of documents in his "in box" or files even though he has not yet read the documents or may be held to be in "possession of" all information in his company's central computer file.

Similarly, with respect to the affirmative defense which is available under the bills to those other than natural persons, such as broker-dealers, banks and other multi-service institutions, the Committee believes that lack of actual knowledge of the non-public information by the trader or decision maker within the entity should be a sufficient defense even if the accused cannot also demonstrate that it had procedures that the SEC, a jury or a court would retrospectively find to be adequate.[11]

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11 Of course, in determining whether any person other than a natural person has sustained its burden of proof, it should be relevant whether, and to what extent, such person had implemented and maintained reasonable policies and procedures to ensure that the individual making investment decisions on its behalf would not misuse non-public information.

It should also be noted that Mr. Cheek dissents from the consensus viewpoint of the Committee on this issue to the extent that he believes that a demonstration of policies and procedures should be a part of the affirmative defense available to other than natural persons, but he believes that once the existence of such policies and (Footnote Continued)

In addition to the inherent difficulty of proving a negative, the SEC Bill's affirmative defense of non-use for entities is subject to a number of criticisms. First, and most importantly, it does not provide any real comfort or protection for multi-service firms. The defense is available only to a multi-service firm if its policies and procedures are "reasonable." There is nothing in the existing law, however, that defines this concept. The SEC has been unable or unwilling to define what constitutes adequate Chinese Wall procedures.[12]

Moreover, there is no clear consensus even among professionals regarding the best approach to controlling misuse of information. Common procedures, such as restricted lists and watch lists, are now being questioned. For example, Mergers & Acquisitions magazine recently quoted one expert as stating, "'[t]o put a stock ... on [such a] list is one of the worst and most notorious signals to the investment community that something is going on. In fact, the clever arbitrageur will try to smoke out what's on that list by calling in and attempting to place orders.'"[13]

The SEC Bill likewise provides no guidance. It merely provides that, to avoid liability, an entity must prove that it has "implemented one or a combination of policies or procedures, reasonable under the circumstances, taking into consideration, among other things, the nature of the person's business, designed to prevent the individual making the investment decision involved from possessing or being influenced by the material, nonpublic information." What this means in any firm's particular "circumstances" is anyone's guess.

The result is that there are no accepted safe harbor procedures which the firm can follow and the efficacy of well

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(Footnote Continued)

11 procedures has been established, the burden should shift to the plaintiff to prove that they were unreasonable.

12 There has been interest in Congress in requiring the SEC to develop such rules, but thus far there is nothing in the law that requires the agency to act. See, e.g., S.1323, 100th Cong., 1st Sess. §15 (as amended at mark-up on Oct. 1, 1987).

13 "Insider Trading Counterattack: Stronger Remedies for Combatting a Pernicious Problem," Mergers & Acquisitions, Nov./Dec. 1987, at 88.

respected and widely used Chinese Wall procedures will become the subject of litigation in every insider trading case. The bills' failure to provide a defined safe harbor is particularly troublesome in light of the express private damage remedies which would be created. There would be absolutely nothing that multi-service firms could do to avoid being targets of strike suits. The bills would not require a private plaintiff to allege or prove that the firm misused information in its possession. Nor would the bills even require the plaintiff to allege that the firm's Chinese Wall procedures were inadequate. The defenses of non-use and an adequate Chinese Wall would have to be raised by the firm in its answer to the complaint. More importantly from a litigation point of view, it appears doubtful that a firm could ever avoid a trial. Even if the firm could establish the fact that its Wall was not breached, it could never obtain summary judgment on the issue of the "reasonableness" of the Wall. This would present a question of fact for the jury to decide. As a result, a strike suit would almost always result in a sizeable settlement.

Even apart from the fact that the possession standard would cause problems for multi-service firms in private suits, however, the bills' overall approach is fundamentally unfair. It would, in the words of the NYSE Legal Advisory Committee, subject multi-service firms to the risk of enormous liability, not because they used inside information for trading, but rather because they are found, based entirely on "20/20 vision in hindsight," to have failed to meet standards which are entirely "vague and uncertain."[14]

F. Private Right of Action Provisions

The proposed bills appropriately provide for express private rights of action under Section 16A, rather than leaving such rights to be implied in derogation of the Supreme Court's teaching in Cort v. Ash, 422 U.S. 66 (1975). The private rights of action provided for, however, appear to vastly expand the categories of recovery beyond those available under existing law while leaving largely undefined the scope and elements of the causes of action provided for. For example, subparagraph (g)(1)A of the SEC Bill and its counterpart in the Reconciliation Draft each provide a cause of action to persons who "contemporaneously trade." The "contemporaneous trader" plaintiffs would not be required to prove that they suffered any causally-related damages in order to recover. Thus, they, like the SEC and federal prosecutors, would be entitled to sue based solely upon the misappropriation theory. This would

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14 Legal Advisory Committee Report at 22.

reverse current law. "Contemporaneous trading" is not defined nor are any details provided as to how a potentially large number of contemporaneous traders are to divide up the limited pool of damages provided for them under subparagraph (g)(2). While the recovery would be limited to the defendant's "actual profit obtained or losses avoided" as a result of his wrongful conduct,[15] a communicator of information would be jointly and severally liable for any profits of direct and indirect recipients of the information if they violated the law by trading.[16]

On the other hand, subparagraph (g)(1)(B) of the SEC Bill and its Reconciliation Draft counterpart seem to provide for unlimited damages to a very broad and undefined group of plaintiffs other than contemporaneous traders. The Reconciliation Draft would authorize any person (other than a contemporaneous trader who is "entitled" to recover in a private disgorgement action) to bring suit against a wrongful communicator or trader to recover any "actual damages sustained" in connection with his purchase or sale of a security.[17] This second type of action would differ from the first in that a communicator of information could be held liable for damages even if the persons to whom he provided the information did not violate the law by trading.[18] The

15 This would codify the "disgorgement measurement" of damages adopted in Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 170 (2d Cir. 1980), to prevent liability for insider trading from being "draconian."

16 Proposed Section 16A(f)(1)(A) of the Reconciliation Draft, which would create the private disgorgement action, would, by its terms, be available only against "a person who violates subsection (b)" — the subsection which prohibits wrongful trading. The disgorgement remedy reaches communicators because proposed Section 16A(f)(3) would make any person who wrongfully communicates information "liable, jointly and severally, with and to the same extent as any persons who obtained profits or avoided losses as a result of such violations of subsection (b)."

17 Proposed Section 16A(f)(1)(B).

18 Proposed Section 16A(f)(1)(B) of the Reconciliation Draft, which would create the private damage action, provides that an action may be maintained by any person "injured by a violation of this section." The section (Footnote Continued)

plaintiff's recovery would not be limited to the defendant's profit, and would not be diminished by any disgorgement made in an SEC enforcement action.

It may be that the authors intend that any such persons will have to prove the traditional elements of a cause of action now required under Rule 10b-5 (i.e. privity, reliance, causation, etc.) in order to recover under this provision, but, if this is the case, none of those requirements are set forth in the statute. The purpose of subparagraph (g)(1)(B) of the SEC Bill and its Reconciliation Draft counterpart was apparently to provide a federal remedy for tender offer bidders who suffer an injury when their plans are illegally leaked and resulting trading increases their cost of acquiring the target company's stock. However, according to the plain language of the bill, the action would be available to "any person" who suffered damages as a result of a violation of the new law. Thus, there appears to be no reason why the cause of action would not be available to market traders who claim they were forced to pay more for a security than they otherwise would have paid but for a wrongful private communication of information.

In the typical case, a corporate officer who communicated material, non-public information in a manner which was arguably "wrongful" could be subjected to both types of suits. For example, in a "good news" situation in which the price of the stock increased as a result of the disclosure, he could be sued by contemporaneous sellers for disgorgement of the profits made by the persons to whom he communicated the information. He could also be sued for an unlimited amount of damages, however, by contemporaneous purchasers.[19] These investors could claim that the officer's communication resulted in trading, that this caused the price of the stock to increase

(Footnote Continued)
18 therefore applies to wrongful communication as well as wrongful trading violations. Further, a person can violate the wrongful communication provision of the bills even if the resulting trading is lawful. Proposed Section 16A(c)(1), which prohibits wrongful communications, requires proof that the communication was "wrongful" and that trading was "foreseeable." But, it does not require that the resulting trading be wrongful.

19 Because the purchasers would not be "entitled to recovery" under Section 16A(f)(1)(A) of the Reconciliation Draft, they would not be barred from suing for their damages under Section 16A(f)(1)(B).

and that they were forced to pay more for the stock than they would have paid if he had not engaged in the wrongful conduct. In a class action, the total damage claims could be enormous under this theory.

Finally, the proposed legislation does little to resolve the thorny questions that have already arisen under existing law concerning who gets what may be a limited pot of money when private plaintiffs seek damages, the SEC seeks disgorgement and treble damages sanctions under the Insider Trading Sanctions Act and the IRS seeks taxes based on the illicit profits earned. In the absence of a clear legislative statement as to how available monies are to be distributed, private plaintiffs, especially "contemporaneous traders," may find that the cause of action provided to them by the proposed legislation is largely illusory.

G. Resort to Legislative History

In SEC Chairman Ruder's letter which accompanies the SEC Bill, the SEC takes the position that its support of the proposed legislation is contingent upon "proper resolution of several important interpretive issues in the bill's legislative history." In addition to the problem that no specific report language has yet been prepared reflecting the points as to which the SEC seeks a favorable legislative history interpretation, so no such report language can be analyzed at this time, the SEC's approach in this respect appears to be a questionable legislative policy. While it may sometimes be necessary in interpreting a statute to consider its legislative history when some aspect of the legislative intent is later put in issue, in its proposal the SEC seeks to rely on legislative history in advance to address matters which are fundamental, rather than merely collateral. The Committee believes that development of legislative history with respect to such matters is not an adequate substitute for statutory language which at least tries within the statute itself to set forth all of its fundamental provisions.

CONCLUSION

I would like to thank the Subcommittee for the opportunity to appear today and express the hope that sufficient time and open comment will be permitted so that all of our joint efforts to put a halt to insider trading will ultimately bear fruit.

ADDITIONAL STATEMENT OF MILTON V. FREEMAN, ESQ.

December 15, 1987

HEARINGS ON S.1380, 100th CONGRESS FIRST SESSION, SECURITIES SUBCOMMITTEE, COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS, UNITED STATES SENATE HONORABLE DONALD W. RIEGLE, CHAIRMAN

Senator D'Amato will recall that in 1984 on the occasion of consideration of the then proposed Insider Trading Sanctions Act, he presented a proposal which appeared to have substantial support, along the lines similar to S.1380.

That proposal was substantially shorter and not as complex and difficult to understand and apply as the proposals currently before the Committee. Senator D'Amato's proposal was only three pages long and appears at pages 8-10 of the Senate Hearings on H.R. 559 on April 3, 1984. It was presented by the Senator on the premise that the misappropriation theory might be shaky and that an alternative was necessary to outlaw inappropriate trading conduct.

At the time the SEC rejected Senator D'Amato's suggestion and indicated that it believed the misappropriation theory was a valid and sufficient basis for preventing improper trading activity. (At the time only Mr. Cox of the present SEC was a Commissioner.)

At the present time, as indicated above, and as the Commission and its staff have publicly stated, the misappropriation theory seems in very much less danger than it appeared to be in 1984. In the interim the Commission has been able, without additional legislation other than the Insider Trading Sanctions Act of 1984, to deal with the largest cases in its history, e.g., Boesky, Siegel, Levine, etc.

Accordingly, it is difficult to understand why it should now be suggested that the existing stronger legal basis for the Commission's jurisdiction should be expanded, especially in such a lengthy and complex manner.

ADDITIONAL STATEMENT OF RICHARD B. SMITH, ESQ.*

December 15, 1987

HEARINGS ON S.1380, 100th CONGRESS FIRST SESSION, SECURITIES SUBCOMMITTEE, COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS, UNITED STATES SENATE HONORABLE DONALD W. RIEGLE, CHAIRMAN

Under the SEC Bill's language an enforcer or plaintiff has to prove more than possession. The prosecution has to prove that the defendant knew or recklessly disregarded either that the information has been obtained wrongfully or that his trade would constitute a wrongful use of such information.

These two concepts, new and central to the aim of the Bill, are defined in a rather confusing way. Trading while in possession of material non-public information is "wrongful only if" the information has been obtained by or its use would constitute (A) theft, bribery, misrepresentation or espionage, or (B) conversion, misappropriation, breach of a fiduciary duty or breach of a relationship that is one ("personal or other") of trust and confidence or is contractual or employment. The way the provision is drafted either the wrongful obtaining or the wrongful use could be any of either of the (A) or (B) category events. One would have thought that wrongful obtaining would be by theft, bribery, misrepresentation or espionage, the (A) group of terms, and that a wrongful use would occur where there is a conversion, misappropriation or breach of a duty, the (B) group of terms. Otherwise, why the separate (A) and (B) categorizations? As drafted, it is not readily apparent what is meant.

The provision could be read to mean that it would be a violation for any person to trade while in possession of material non-public information because that fact alone would be construed to constitute a misrepresentation to the counterparty ... even though the person who traded came into possession of the information lawfully (not by theft, bribery, misrepresentation or espionage) and even though he had no fiduciary duty, or trust-and-confidence, contractual or employment relationship to breach toward the issuer, the transmitter of the information or the counter-party. Such a not altogether strained reading would take us right back to the properly rejected concept that inequality of information is an actionable offense.

The SEC itself, in its November 18 letter transmitting the Bill, showed a similar concern. It indicated that the SEC's support for the bill would be contingent on the legislative history making clear that the Bill's use of the terms "misappropriation" and "conversion" refer to "possession <u>and</u> use of information in breach of a <u>pre-existing</u> duty of confidentiality or non-use arising from the expectations of the parties, or arising from law. The proposed Section 16A(b) per se does <u>not</u> create such duties, nor would Section 29 of the Securities Exchange Act invalidate otherwise lawful agreements to waive any such pre-existing duties." (Emphasis added.)

A statutory text that leaves sufficient doubt to require legislative history on that fundamental point must be suspect.

* Mr. Bialkin joins in Mr. Smith's additional statement. Because of the timing constraints involved in preparing this testimony for the Senate Banking Committee, other members of the Committee did not have an opportunity to determine whether they would similarly join in this additional statement.

SEPARATE VIEWS OF JOHN F. OLSON, ESQ. AND HARVEY L. PITT, ESQ.

December 15, 1987

HEARINGS ON S.1380 100th CONGRESS FIRST SESSION, SECURITIES SUBCOMMITTEE, COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS, UNITED STATES SENATE HONORABLE DONALD W. RIEGLE, JR., CHAIRMAN

As the Subcommittee is aware, we have been actively involved in the drafting and refinement of S.1380. In our view, insider trading legislation is vitally necessary, especially after the failure of the Supreme Court in the Carpenter case to address any of the present uncertainties in the current law of insider trading. We encourage the Senate Banking Committee to continue its leadership role in bringing clarity to this area of the law.

Although we believed, and still believe, that S.1380 reflects a sound approach to the clarification of the law of insider trading, a view widely supported by both the private and public sectors (including the United States Attorney for the Southern District of New York), we recognize that the SEC has identified areas that this Subcommittee appropriately should consider in determining the final shape of any insider trading legislation.

The SEC's thoughtful proposal is, in most material respects, similar to our own proposed reconciliation amendments to S.1380. Together, the two proposals represent a sound basis for the adoption of clear, meaningful legislation, and we believe that their common basic approach, arrived at after months of careful deliberation, represents a sensible balancing of all relevant interests.

We know that the Subcommittee will, and we believe should, give careful consideration to the views of Kenneth J. Bialkin, Chairman of the Ad Hoc Committee established by the American Bar Association to consider S.1380 and any refinements thereto. In the final analysis, however, two important points militate strongly against the views articulated in Mr. Bialkin s statement.

First, the need for new legislation is amply confirmed by the many factors we have previously brought to the Subcommittee's attention. Mr. Bialkin's suggestion that legislation is either not necessary, or that the reach of current laws regarding insider trading should be drastically curtailed, flies in the face of the empirical evidence that a broad, but fair, plain-English statutory prohibition of insider trading is most assuredly in the public interest, and is necessary to deal with an insider trading-related scandal of unfortunately major proportions.

Second, as Mr. Bialkin himself states, his views should be considered solely as that -- the views of a knowledgeable individual. Those views are not, of course, the views of (i) the full ABA's Ad Hoc Committee (which consists of eleven members), (ii) any constituent body of the American Bar Association, (iii) the American Bar Association itself, or (iv) the two of us.

We commend the American Bar Association for its continuing interest in this important subject, and are grateful for the support we have received from that organization and the members thereof We trust that the time constraints confronting the ABA s Ad Hoc Committee, and the preparation of Mr Bialkin s individual views will not be misconstrued as any waning of the broad-based support previously expressed for S.1380. We look forward to working with the Subcommittee to see this legislation through to a successful conclusion.

SEPARATE STATEMENT OF A. A. SOMMER, JR., ESQ.

December 15, 1987

HEARINGS ON S. 1380, 100th CONGRESS, FIRST SESSION SECURITIES SUBCOMMITTEE, COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

I am a member of the Ad Hoc Committee to Consider Insider Trading Legislation appointed by the Chairman of the ABA Section of Corporation, Banking and Business Law, Robert L. Berner, Jr., to assist the Congress in developing legislation relating to insider trading. I have attended, I believe, all but one of its meetings. At various times I have been chairman of the ABA Section on Corporation, Banking and Business Law, chairman of the Federal Regulation of Securities Committee, and a member of the Securities and Exchange Commission.

Judging by its membership the Committee was constituted to bring together those members of the ABA Section Corporation, Banking and Business Law who had been most closely identified with present and past efforts to deal with insider trading through legislative means, plus others who have been in various capacities familiar with the problem.

I think it was the intention of Section Chairman Berner when he appointed the Committee that it be a catalyst, a means of resolving disagreements among approaches to legislation and of bringing to the Congress a true consensus approach to this very important problem.

Alas instead of achieving this result, the Committee has for a number of reasons been, if anything, the source of e more strident disagreement. This has largely resulted from the time pressures under which the Committee has operated. All of its members are extremely busy practitioners and hence attendance at its meetings was often impossible for some of the members At the second to the last meeting of the Committee, which I attended, there were only three members of the Committee present. True, at that meeting and others "proxies" for some of the members attended, but they did not bring to the meetings the expertise, experience, insights and authority that their principals would have brought.

There were simply too few opportunities for the talented members of the Committee to achieve what it was hoped they would accomplish: hammer out a true consensus that would derive its authority from their experience and expertise and their active participation in the process of carving out the conclusions of the Committee.

Memoranda, hastily transmitted telexes, telephone calls and questionnaires are not substitutes for face-to-face debate and careful deliberation, procedures which happily characterize this body, the United States Senate. Consequently, the thoughtful statement of Mr. Bialkin, while containing many helpful suggestions for improving the proposed legislation, should not be seen as more than it is.

It would have been extremely helpful to the Committee in carrying out its mission if there had been an opportunity for Messrs. Olson and Pitt and members of the SEC staff who helped craft the proposed legislation to present to the full Committee its members, not their proxies -- the considerations which cause them to support the proposals. That opportunity did not present itself, hence the Committee was seriously handicapped in its work.

It is important for this Subcommittee to understand that none of the procedures of the American Bar Association that would permit anyone to state a position of the Association have been followed with respect to Mr. Bialkin's statement before the Subcommittee. The Council of the Section has not approved that statement. The Federal Regulation of Securities Committee of that Section, which ordinarily has jurisdiction over all matters relating to federal securities law, has not approved it.

The statement should be seen for what it is: the statement of small number of well-informed experienced, concerned securities lawyers

Having said this, I would suggest that many of the comments by Mr. Bialkin should be carefully considered by this Subcommittee as it considers the proposals before it. In my estimation, many of the dangers seen by Mr. Bialkin if the legislation in the form proposed is adopted are overdrawn but there has in my experience never been a piece of securities legislation, including the Securities Act of 1933, the Securities Exchange Act of 1934, the 1975 Amendments to the Securities Acts and all the rest, that has not been seen by some as threatening the very foundations of the republic. Still, there is considerable merit in some of the misgivings expressed by Mr. Bialkin.

Because of my belief that some of the faults seen in the proposed legislation by Mr. Bialkin are without foundation or are exaggerated by him, and because of the lack of sufficient opportunity for the Committee to adequately consider the considerations underlying the current legislative draft and perhaps reach a true concensus, I wish to disassociate myself from Mr. Bialkin's statement.

I hope that the Ad Hoc Committee will continue its deliberations and pursue the goal of achieving a consensus among its extremely knowledgeable and experienced members that will assist this Subcommittee in formulating legislation that will be fair, effective in promoting full disclosure, and at the same time hard in its strictures on those who misuse material undisclosed information.

Senator RIEGLE. Well, I appreciate the points you have raised here. Let us hear now from Mr. Cox.

STATEMENT OF JAMES D. COX, SCHOOL OF LAW, DUKE UNIVERSITY

Mr. Cox. In the interest of time, I will just identify four problem areas of concern with the current statute.

I want to underscore, first of all, that I share Professor Langevoort's view that one of the major problems with this statute is the privatization of the wrongfulness idea. I think we ought not to be able to allow the Foster Winans and the friends of Foster Winans to escape the reach of the securities laws because Dow Jones says, "We won't raise your salary, but you can trade on advanced knowledge of what's going to appear in your column." So I think that we must anchor the prohibitions in the public interest and not the private interest in this area.

In my prepared statement, I set forth several mechanisms, as Professor Langevoort did, as to how this can be accomplished.

The concern I have is the exclusivity problem with the regulation. First of all, this is out of step with over 50 years of history under the Federal securities laws. To carry out the broad remedial purposes of the Federal securities laws the remedies are viewed as cumulative.

TRADING RIGHTS CUT OFF BY STATUTE

Furthermore, at the last full page of my testimony, I identify several situations in which individuals are harmed by tipping and individuals are harmed by the trading of others, whose rights would be cut off by this statute.

For example, in our own State of North Carolina last summer, Burlington Industries was successful in warding off a takeover attempt because one of its former financial officers was found to have passed on information to the hostile bidder and was able to protect itself in that case against the misuse of that information. This legislation would cut that right off. There are other examples in my written statement.

So we would be cutting off the rights of individuals who are harmed by tipping as well as those who are harmed by trading.

Related to this is a concern that Senator Bond has addressed earlier, and that is the abolition of respondeat superior liability. On this point, it seems strange that we are singling out insider trading for the release of respondeat superior liability, whereas if the broker commits a churning violation, the broker places the client into unsuitable securities, or the broker puts a customer into a stock on a false representation—in each of those situations, the brokerage house is responsible under the doctrine of respondeat superior.

It seems drastically out of step with what the Supreme Court said, which was not a divided Supreme Court—there was no dissent in the *Bateman* case, and I quote one sentence here—"We believe the deterrence of insider trading most frequently will be maximized by bringing enforcement pressures to bear on the sources of

the information, corporate insiders and broker-dealers." The broker-dealers being referred to there as the brokerage house.

Related to this is that the provisions of the compromise bill, as well as S. 1380, do not impose any control person liability at all for wrongful tipping. When we look at the provision, for example—in just the interest of time, subsection (b)(2) of the SEC compromise bill, that provision only picks up for wrongful trading in (b)(1) as well as (d)(1), but not for tipping in subsection (c). So there is a major gap; tipping individuals would be protected from any responsibility and their employers would be protected from any responsibility if their employees wrongfully tip in flagrant violation of the act. That is an intolerable situation.

Related to this, and to introduce some level of balance in my presentation, I share the SIA's concern that this legislation introduces an unneeded uncertainty with respect to tipping because the prohibitions include, as represented earlier, a mere breach of fiduciary duty. A careful reading of the *Dirks* case, which is set forth in my prepared testimony, shows that the Court very clearly introduced a brightline test, that wrongful tipping, when it does not occur to a friend or relative, requires the showing that there's been a pecuniary gain or reputational benefit which will translate to a pecuniary gain in the tipper. What this legislation, both S. 1380 and the SEC compromise bill does, is introduce the vague standard of what do we mean by a fiduciary obligation. Any breach of fiduciary obligation would make the possession or transmission of that information wrongful and that introduces a serious impediment to the legitimate functioning of investment analysts where society benefits greatly by their aggressive pursuit of information.

I think that whatever statute we have ought to be consistent with the Dirks language that I quote in my prepared testimony.

Thank you for allowing me to share my views on these points with the committee.

[The complete prepared statement of James D. Cox follows:]

Testimony of
Professor James D. Cox
Duke University

Before the

Securities Subcommittee

of the

Senate Committee On Banking, Housing, And Urban Affairs
December 15, 1987

My name is James D. Cox. I am a professor of law at Duke University and a commentator on insider trading issues. I very much appreciate the opportunity to share with this Subcommittee my comments and criticisms of both S.138 and the "compromise bill" sponsored by the SEC in its November 18, 1987 letter to the Subcommittee.

It is imperative for the Congress to enact a broad proscription of insider trading practices. The Supreme Court's even division in Carpenter v. U.S. over the viability of the misappropriation theory casts a menacing shadow over the continued effective enforcement of insider trading rules. As the Subcommittee is aware, a significant portion of the government prosecutions have proceeded under the misappropriation theory. Generally, the defendants in the numerous misappropriation cases have been various types of professionals who have abused their confidential positions with or through one corporation to acquire the stock of another corporation using their secret knowledge of a tender offer, merger, restructuring and the like. Because they have fiduciary relationship to the investors of the corporation whose stock they purchased, such defendants are beyond the "disclose or abstain" mandates for insiders as recognized in Chiarella v. U.S., 445 U.S. 222 (1980) and can only be prosecuted as a misappropriator. See e.g., U.S. v. Newman, 664 F.2d 12 (2d Cir. 1981).

It is important that we regulate insider trading. The "findings" in Sections 16A (a)(1)-(4) of the SEC compromise bill capture nicely the broad range of concerns which justify the regulation of insider trading. This regulation, however, does not occur without some question whether and how insider trading offends the purposes generally ascribed to the federal securities laws, most importantly to the antifraud provision, Section 10(b) and Rule 10b-5, which to date has carried the regulatory burdens in this area. These concerns are particularly great when such regulation occurs through the misappropriation theory. Simply put, the antifraud provision and most of its sister provisions are designed to facilitate informed investment decisions, to protect capital markets from manipulation of stock prices, and generally to sustain investors' confidence in the integrity of our capital markets. In contrast, the misappropriation cases emphasize the "unfairness" to the employment relationship, regardless of the impact upon another's investment decision. See e.g., SEC v. Materia, 74 F.2d 197, 201-202 (2d Cir. 1984).

Even under a strict application of the disclose or abstain rule to managers who trade in their employer corporation's stock there is a discontinuity between protecting investor judgments and proscribing the insider's trading. To wit the investor's decision to sell or purchase is unaffected by whether the insider is also secretly buying or selling shares in the open market. If the insider neither trades nor discloses his confidential material information, one can nevertheless expect the investor to pursue his trading plan. To be sure, sellers are naturally disadvantaged by the nondisclosure of good news, just buyers are disadvantaged by the nondisclosure of bad news. These considerations, however, cast no light on why the inside 's decision to trade should prompt disclosure. In the end, the insider's secret trading is for his opposite trader a mere fortuity.

The above does not reject the necessity of regulating inside trading. It suggests that the justification for regulation lies in concerns broader than the protection of individual investors against concealed trading or the protection of employee-employer expectations regarding the proper uses of the employer's information.

We Should Not Privatize The Basis for the Prohibition

Both S.1380 and the SEC compromise bill contain a troubling discontinuity between their findings justifying proscription of insider trading in (a)(1-4) and their definition of what renders a use or acquisition of information "wrongful." Each bill's findings emphasize that "wrongful" trading interdicts the "fairness, efficiency and integrity" of capital markets. However, the bills' definition of wrongfulness rests upon purely private considerations such as the "theft", "bribery", or a "breach of fiduciary" duty. Therefore, the wrongfulness of the defendant's act is determined not by a perceived harm to investors or to markets, but to the party from whom the information was obtained by "theft", etc. Without more, the bills therefore fail to answer the prevalent question: why and how does the unauthorized use of another's information justify regulation through the federal securities laws? Moreover, there is a grave danger that such a privatized view of insider trading will ultimately cause our present concern for preserving the integrity of fair and efficient capital markets to be subordinated to the vagaries of private arrangements between the defendant and his employer. Just as the successful prosecution of Mr. Winans should not have been scuttled if his employer, Dow Jones and Company, had licensed him to trade on the advance knowledge of companies touted in his column, the proscription of trading which poses a threat to the fairness and efficiency of

couple of ways to [illegible].

Distinction between Inside-Market Information Serves An Important Regulatory Function

The most forthright manner to correct this problem is to redraft section (b)(1) to preserve the current distinction between "inside" or "market" information. The former is your traditional insider trading situation illustrated by the classic decision in SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968). Inside information bears on the performance or position of the corporation whose shares are traded in by its fiduciaries. As to inside information, the demands of the disclose or abstain rule are much greater. Even the corporation's trading in its stock is proscribed. A somewhat lower level of regulation occurs in the case of market information. Market information is created outside the corporation whose shares are traded. Market information concerns events and circumstances which do not affect the corporation's assets or earnings, e.g., a pending hostile tender offer for the target corporation's shares. S. 1380 and the SEC compromise bill indirectly recognize this distinction between inside and market information in their sections (c)(2) and (d)(1)(2), respectively. Each bill therein proscribes some, but not all, discrete tipping of market information. I propose that this distinction should be emphasized in the interest of more strongly anchoring the proscriptions of this act into concerns germane to the federal securities laws so that regulation will not depend upon narrow private arrangements.

The more demanding level of regulation as to inside information is justified to avoid the risk that information flows within the corporation as well as the corporation's public announcements will not be subordinated to the insider's secret trading agenda. The potential for such abuse is not nearly as prevalent in the case of market information. There is the further belief that the generator of market information should generally be able to trade on it without disclosing the information, and should be free to license others, including its employees, to so trade. Nevertheless, there is a great need to protect capital markets from the abuses which can accompany the misappropriation of market information. The recent revelations surrounding the trading practices of Messrs. Dennis Levine and Ivan Boesky reflect an eagerness of some not only to misappropriate market information but also to engage in a wide array of manipulative practices to increase their unlawful gains. Thus, there is a serious concern that misappropriated market information may precede or accompany classic forms of market manipulation. For this reason, the concepts of wrongfulness should be the predominant proscription of one's use of market information.

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the above suggestion, the following should be added as legislative history to connect the proscription of the "wrongful" use or communication of information with a need to preserve the integrity of fair and efficient capital markets.

Necessary Addition to Legislative History

There is growing evidence that insider trading is sometimes accompanied by abusive disclosure practices and other manipulative practices. For example, FMC Corporation's investment banker intended to withdraw its involvement in a corporate restructuring unless the price to the minority shareholders was raised $10. On the basis of their secret knowledge of this dispute, Messrs. Boesky and Levine alledgedly undertook massive purchases of FMC stock for the purpose of causing FMC's management to approve the higher price. FMC Corp. v. Boesky, [1987 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶93,223 (N.D.Ill. 1987). See also, In re Orfa Sec.Lit., [Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶93,225 (D.N.J. 1987)(misleading statements and delayed reports of company's performance accompanied insider trading); and Froid v. Berger, [1987 Transfer Binder] Fed.Sec.L.Rep.(CCH) ¶93,201 (D.N.J. 1986)(unduly optimistic forecasts issued when managers were selling corporation's stock on knowledge that forecast will not be met). Thus, these and other cases justify our concern that insider trading can lead to abusive disclosure practices and other manipulative conduct for the purpose of increasing the insiders' trading profits. Tardy corporate disclosures would be the most likely form of manipulation. The delay gives insiders and others the time needed to capture a greater share of the change in the firm's value. Ambiguous corporate disclosures and signals that are used to create market uncertainty are an even more ingenious form of manipulative trading practice. For example, insiders may use ambiguous announcements to enter the market and purchase their firm's securities at a lower price and to dispose of the stocks at a higher price following a later definitive disclosure. Insiders may even alter the timing of corporate activities for the sole purpose of creating intertemporal swings in the firm's value; they thereby can reap the gains of their privileged positions by anticipating the direction of the stock's price movements.

With an appreciation that a linkage between such abusive practices and insider trading can occur, minimally it is appropriate to consider the severe regulation of the latter out of a prophylactic concern of deterring the former. That is, great uncertainty exists as to whether sound managerial judgment or the insider's hidden trading agenda drives an announcement's timing or its ambiguities, the initiation or delay of a corporate transaction, or the selection of riskier projects. Insider trading regulation is a more administratable approach to these

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potential abusive and manipulative practices because it achieves two results by removing the corrupting incentive of insider-trading profits. First, regulation eliminates the highly problematic matter of proving that the insider's desire for private gain, rather than the corporate interest, motivated the disclosure, event, or project. Second, regulation focuses concern upon a single event - whether the defendant traded while in possession of material nonpublic information. Inquiry into this better lends itself to external analysis than does a subjective managerial business decision concerning corporate disclosures and operations.

There is a need to legitimize insider trading regulation. It is this need which drives the Subcommittee's current inquiry. That need is hastened by the indecisive outcome of the misappropriation theory in U.S. v. Carpenter. This need is not served under either S.1380 or the SEC compromise bill because both define the "wrongful" use or acquisition of information in purely private concerns. Each bill gives insufficient attention to the larger public considerations which move the justification for proscribing insider trading from narrow concerns of "theft", "bribery" or "breach of fiduciary duty" to a larger concern for fair and efficient securities markets. The connection I offer between insider trading regulation and curbing manipulative market practices is not a new one. When the Congress originally proscribed short-swing trading profits under section 16(b) of the Securities Exchange Act of 1934, the Congress did so out of a concern that insider trading activity can lead to abusive and manipulative collateral practices. See S. Rep. No. 792, 73d Cong. 2d Sess 9. The report for the Insider Trading Proscriptions Act of 1987 should similarly identify these concerns so as to overcome any possibility that the Act's proscriptions are seen as depending upon protecting solely private rights. I urge that the Subcommittee go further. The bill supported by this Subcommittee should anchor the prohitions of trading on "inside" information on a broader concern that fairness, efficiency and the integrity of securities markets contemplate that neither the corporation nor its employees may purchase or sell that corporation's securities on the basis of material nonpublic information. Those in possession of market information may generally use their information for themselves, but those who acquire such information by "theft", "bribery", etc. should not be allowed to so trade.

Change in Law of Tippee Liability

Subsection (c)(1) of S.1380 and subsection (c) of the SEC compromise bill each proscribe "wrongful" tipping. A tip is wrongful if, among other reasons, it constitutes a "breach of fiduciary duty." It is my belief that this represents an undesirable change in the existing case law. Under Dirks v. SEC, 463 U.S. 646 (1983), a tip violates the antifraud provision only when the 'insider's "tip" constituted a breach of the insider's fiduciary duty.' Id. at 661. The Court then narrowed this

consideration by reasoning, "the test is whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders." Id. 662. Finally, the Court later emphasized that the inquiry "requires courts to focus on objective criteria, i.e., whether the insider receives a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputational benefit that will translate into future earnings." Id. at 663. The sole exception to the requisite receipt of a pecuniary gain is the Court's proscription of tips "to a trading relative or friend." Id. 664. Therefore, the Supreme Court in Dirks repeatedly emphasized not simply a breach of a fiduciary duty, but rather a breach objectively verifiable by the insider's receipt of a pecuniary gain. The Court justified this "brightline" standard out of a concern that analysts may otherwise be pillored for their utilization of information secured through an aggressive, albeit socially desirable, investigation. Id. 664. The definition of wrongful tipping in both S.1380 and the SEC compromise bill should reflect the position of Dirks by rendering unlawful tipping and trading on tips (certainly as to analysts) whenever either a direct or indirect pecuniary gain is reaped by the tipping insider, or the tippee is a friend or relative. The change I proposed in the bills would continue the protections that analysts currently enjoy under Dirks. This protection is necessary to facilitate analysts in their aggressive pursuit of information and whose efforts ultimately lead to more efficient securities markets.

Provisions Should Not Be Exclusive

Subsection (g) of S.1380 and subsection (a)(5) of the SEC compromise bill each render their prohibitions exclusive. One effect of this is to foreclose private rights of action by any person other than the group of traders specifically identified in subsection (f) of S.1380 and subsection (g) of the compromise bill. The prohibitions of the bills should not be exclusive. First, such a position is seriously out of step with over 50 years of practices under the federal securities laws. It is well recognized that the remedies under the many provisions of the federal securities laws are cumulative. This underscores the broad remedial purposes of the federal securities laws. Second, exclusivity is not merited by any justifiably based concern that defendants suffer unfairness because of uncertainty as to section 10(b)'s and Rule 10b-5's proscription of inside trading. The antifraud provision does not reach those who inadvertly trade on confidential inside information. Certainly the lengthy line of misappropriation cases reveal well-conceived schemes first to purloin another's information and second to trade upon that stolen information. In this regard, I believe that there are greater uncertainties presented by the current untested bills. For example, S 1380 and the SEC compromise bill each remove Dirks' "brightline" standard of a pecuniary gain so that the bills add uncertainty to the inquiry whether one is a tippee. Moreover, [illegible] case law offers scores of factual [illegible]

situations and judicial opinions which in combination offer a fully textured view of the law of insider trading. A third concern raised by exclusivity is that investors most injured by insider trading would be deprived under the exclusivity provision of a right to sue. For example, the courts have recognized the right of the target corporation to enjoin a hostile tender offeror where the latter has used information from a former target insider to make its hostile takeover. See Burlington Ind. Inc. v. Edelman, [1987 Transfer Binder] Fed.Sec.L.Rep.(CCH) ¶93,339 (4th Cir. 1987) aff'g Burlington Ind. Inc. v. Edelman, [1987 Transfer Binder] Fed. Sec. L. Rep.(CCH) ¶93,338 (M.D.N.C. 1987). See generally, Cohen, "Ex-Employees Who Join Takeover Plots Can Expect Their Former Bosses to Sue," Wall St.J. July 7, 1987 at 31, col. 4-6. Furthermore, the on-going suit against Paul Thayer and others concerns the illegal tipping by Mr. Thayer, a director of Anheuser-Busch Corporation. He revealed Anheuser-Busch's plan to make a tender offer to the stockholders of Cambell Taggert. Inc. As a consequence of Thayer's tip, a significan increase occurred n the marke price of Cambell Taggert stock before Anesheuser-Busch announced its offer. To assure tha ts tende offer would be successful, Anheuser-Busch raised its offering price In this case, the wrongful tipping and tippee trading harmed Anheuser-Busch. This harm is much easier to visualize than the harm, if any, suffered by nvestors who sold their Cambell-Taggert shares to Thayer's tippees (recall my testimony earlier at page 2 regarding the the fortuitous nature of nsider trading vis-a-viz other market participants). The exclus vity provisions of both bills, however will foreclose the protections of the federal securitie laws to uture "Burlington Industries" and "Anheuser-Buschs who have unquestionably been harmed because their insider have wrongfully tipped material inside information. For this reason, I believe the Subcommittee should remove ll reference to exclusivity and thereby cont nue the wel establ shed and justifiable practice tha the prohibitions and remedies of the federal securities laws are cumulative.

Abolition of Employers' Respondeat Superior Liability

Section (d) of S.1380 and subsection (b)(2) of the SEC compromise bill each immunize employers' from vicarious responsibility for wrongful tipping committed by their employees within the scope of their employment. [It should be observed that subsection (b)(2)(B) of the SEC compromise bill merely requires reasonable protections and practices against an employee trading not an employee's tipping on the basis of wrongfully acquired information.] Nearly all the ircuit courts of appeal have recognized that the common law doctrine of respondeat superior applies to violations of the federal securities laws. For example, brokerage houses are held responsible under this doctrin when their account executives churn customer accounts, induce trades into unsuitable securities and make false representations of material facts. There appears no reason to justify making an exception to

respondeat superior liability when the account executive or any other employee unlawfully tips his customers. Moreover, there appears no reason why controlling person liability should not apply to tipping; however, both bills not only eliminate employer liability based on the doctrine of respondeat superior but also do not expose the employer or others to controlling person liability when an employee has tipped. Such exceptions are dramatically out of step with the serious responsbility and unique position that brokerage firms have in protecting against unlawful tipping as emphasized by the Supreme Court in Bateman Eichler, Hill Richards, Inc. v. Berne, 472 U.S. 299 (1985). To be sure, there has been little occassion for employers to bear the consequences of their employee's unlawful tipping. Nevertheless, to the extent these acts occur within the scope of the tippee's employment they should be viewed as the risk of the employe 's enterprise and the employer should be responsible for the resulting harm. This is the position taken by most of the circuit courts of appeal, it is the bette position, and it is the position this Subcommittee should take in view of your serious concern for curbing the abuses of insider trading.

In closing thank the Subcomittee for allowing me to share my views on how S.1380 and the SEC compromise bill may each be improved. I am available to your staff and others as the need arises to assist in whatever way I can to draft language which will overcome the weaknesses that each bill contains.

Senator RIEGLE. Well, thank you for very thoughtful comments and also for your full statement which we will make a part of the record.

Professor Langevoort, in your testimony you state, "In my view, the case for legislative reform in the area of insider trading is compelling."

Professor Cox, you state, "It is imperative for the Congress to enact a broad proscription of insider trading practices."

I'm wondering if you can just briefly indicate why each of you feels so strongly that legislation is necessary.

Mr. LANGEVOORT. My response, I guess, would come at two levels.

First of all, as this subcommittee has pointed out repeatedly, and as Congress has pointed out repeatedly since 1933, a level of investor confidence in the stock market is absolutely essential to provide the liquidity necessary for the effective functioning of the stock market. People are just not going to invest—are not going to have the confidence that investment is a worthwhile thing to do—unless they believe the rules are fair.

In addition, if you tolerate insider trading, the system of securities regulation that depends on affirmative disclosure of information will break down. Corporate insiders are going to be reluctant to make public information that they can later trade on.

I think those two reasons come together to provide a fairly compelling case for prohibiting insider trading.

Having said that, the question becomes: Is current law adequate to carry out those objectives? My sense is that it is 90 percent adequate. It's workable, as I said in my prepared statement. But I fear that when the Commission or Federal prosecutors bring fairly visible cases, and those visible cases turn on difficult and uncertain legal issues, such that the Commission might lose them, the message to the public may well be that we don't have an adequate system of SEC enforcement or criminal enforcement of the insider trading laws. For example, I consider the misappropriation theory still substantially up in the air, and still quite capable of disappearing as an enforcement tool.

For that reason—having come to the conclusion that insider trading ought to be prohibited—I am convinced that our system of law needs to be adequate. And my sense is that 90 percent is not good enough.

Senator RIEGLE. Mr. Cox.

THE NEED FOR LEGISLATION IS NOW

Mr. Cox. I would add to that that the ongoing revelations—and I hope there will be more revelations—concerning Messrs. Boesky, Levine and others—are showing that insiders are not just content to take all they can kill as such; they want to actually fill the fields with more prey. And what we find here is that insider trading is more often than not being accompanied by other market manipulations than this—manipulation of real events, manipulations of disclosures—and that adds further to the investor distrust in the securities markets because what happens when insider trading suddenly becomes an overarching agenda of individuals to try and then increase their profits by manipulating disclosure practices or

market events to feed their practices. So I would say that that's an additional reason for wanting to regulate.

The reason we need legislation now is to legitimize the misappropriation theory, which is the only game in town for reaching individuals who are not technical insiders and we need to legitimize that because of the grave uncertainty, unexplained uncertainty by a four-to-four vote.

Senator RIEGLE. Mr. Bialkin, you are flanked by one person who feels there's a compelling need and another person who thinks there's an imperative need. What's your view? Also, you've commented on the SEC proposal and your concerns with that, but I'd be interested in knowing how you feel about S. 1380 specifically.

Mr. BIALKIN. It should come as no surprise to anyone that insider trading is, has been, and will always be illegal. It isn't as though these things have existed without severe sanction already ever since *Cady Roberts,* the *Texas Sulphur* cases: we have had rule 14(e)(3). There hasn't been an important prosecution that has failed where insider trading has been detected.

My testimony shouldn't be taken in any respect as not feeling vehemently resentful of anyone who interferes with market processes by taking unfair advantage of his position or opportunities. That's not the point.

The point is, it is already illegal. Too many people have gotten away with it. There is a lot that hasn't been detected. There are cases that haven't been brought, but they haven't been brought not because the law doesn't exist to sanction what is there, they haven't been brought because factual predicates and discovery apparently haven't been sufficient to supply the evidence which would fit into an existing body of law.

The affirmance of the *Winans* case in clear and resounding terms have applied the mail fraud and wire fraud statutes to the type of fraud involved in insider trading in the broadest possible way. The affirmance also of the judgment of the 2nd Circuit, certainly as to the 2nd Circuit and certainly as to the enforcement policies of the SEC in pursuing the misappropriation theory, hasn't slowed down in any respect the enforcement program of the SEC and doesn't leave them without weapons.

The question really is whether additional legislative tools to be provided by this committee and the Congress are necessary and essential. The question isn't whether insider trading is good or bad; it's terrible. The question is whether the additional legislation as a matter of the balancing that goes into every piece of legislative action that you do, brings more to the table or creates uncertainties and risks and creates problems which you don't really wish to create.

The thrust of my testimony is that, conceding and agreeing fully that it's a terrible and pernicious practice, that the bills in their present formulation don't add enough to what may be compared to the uncertainties that they introduce to require more than already exists in the arsenal of defense against insider trading.

Now, you're quite right, Mr. Chairman. In my testimony I refer to the SEC proposal. I wanted to make it clear that I was also referring to the so-called reconciliation draft S. 1380 because it has moved from the June introduction, and our comments treated

those bills in parity because they have been brought very, very close to each other. There are some differences, but fundamentally the differences didn't seem to us to be sufficiently clear and in the time available, since the reconciliation draft only became available after the SEC bill was made available the week of November 18, it's only been a few weeks—we've had a devil of a time with eleven people traveling all over the world getting together, which is the reason my testimony, as I reported, is individual, although it reflects a consensus of eight out of the eleven and I want to stress again I do not speak at this moment for the ABA.

What we will do following this time and following any further emanations or evolutions of your subcommittee—and I hope you will continue and look at some of the things we wrote—we want to be constructive. We want to be helpful. The purpose of our comments is to try to bring the legislation you are proposing into a formulation that will deal with the problem in the proper balance of law enforcement without stifling the important free flow of market information, free flow of analyst information.

Security analysts have got to go there and attack a corporate executive and push as hard as he can. He's got to get as much information as he possibly can and then disseminate it. And there ought not to be a risk on those who give information or those who receive information that because of some cumulation, or mosaic, or panoply or totality of information, that they get tripped up in circumstances where the free flow of information to an informed public requires the maximization of intercourse of financial information. That's all we're trying to achieve. We're not trying to protect a crook. We want the crooks put away as much as you do.

Senator RIEGLE. Let me ask you to take, if you would—I realize the time hasn't been lengthy—to take a look at the modifications to S. 1380, but I would like you to circulate those among your folks and see if, with a longer look, it doesn't maybe take on a little more attractive visage.

Mr. BIALKIN. We will try to be very constructive, Mr. Chairman.

COUNSELING BROKERS OR ARBITRAGEURS

Senator RIEGLE. Good. I appreciate that. One other thing and then that will finish my questioning and I'll go to my colleagues. Mr. Bialkin, as a securities lawyer, when you're counseling brokers or arbitrageurs on matters that relate to what we're discussing here, do you feel comfortable that you can say to them today with real clarity and precision exactly what is or is not permitted under the law?

Mr. BIALKIN. So far as insider trading is concerned, if it gets to a point where a client consults a lawyer, you can almost always protect the client. Of course advice is going to be conservative as we focus on the issue.

Senator RIEGLE. But that's sort of after the fact. I think I'm trying to pose the question more before the fact.

Mr. BIALKIN. I know, I'm saying that before the fact they come and say, "Are we free to buy or are we free to sell under these circumstances?" The analysis we would go through is the information

material, are you privileged, is it public, and you do it; and generally, the advice would be of a cautious nature.

The insider traders that have come to public attention, had they sought advice or had they consulted themselves, they would have known right from wrong. Most of these issues are not close questions. Their susceptibility is to greed, except in the cases of the structure of the brokerage firms where they sometimes find themselves hurt by the actions of their employees. This has been the subject of other testimony here, that it's important to try to provide safe harbors and to provide assurances that if a Chinese wall is established, policies established are in fact followed and employed, that these firms and institutions ought to have the security of knowing—if they are honest and if they enforce it, if they have compliance people following it—that they are not going to be the victim of a sudden death accusation. Something slipped through and all of a sudden they're on the short end of a class action suit. That's not constructive and it's not healthy and it's not in the interest of the free flow of information.

Senator RIEGLE. But what about cases that are really close call cases? What about the *Freeman* case, the *Tabor* case, things of that kind, not necessarily the specifics of those cases, but illustrations like that? It seems to me, of all the people I talk to, you seem to have a clearer sense of exactly where the line is and what's within the law and what's outside the law. Yet, when I talk with so many others, I find that there's a zone here that is not that clear-cut and I hear a lot of people who are practitioners say that's unsound, it ought to be clearer, we ought to draw that line more sharply. Look at the Supreme Court and the Supreme Court is split right down the middle.

Mr. BIALKIN. There are plenty of issues in securities laws which are maddeningly complicated and certainly very difficult to decide.

I don't believe the question of insider trading normally fits that category. You refer to the *Freeman* and the *Tabor* cases. There are no such cases as yet. People were arrested and indictments were withdrawn. If in fact, forgetting about those names, the type of conduct supposedly alleged in those cases is true——

Senator RIEGLE. That's the way I meant to pose that.

Mr. BIALKIN. Namely, that there were people in positions of trust who, by reasons of arrangements with suppliers of information, obtained that information in consideration of payments and benefits, if those things existed, the people doing that know what they're doing is wrong. And if they are caught, they deserve to be prosecuted to the full extent of the law.

The questions in that case are always, what are the applicable facts? If the facts are as alleged, I don't think there's any question but that the law as presently affirmed by Winans and even by the split decision on the 1934 Act aspect of Winans, would be sufficient to cover those alleged wrongdoings.

As a practicing lawyer, I don't think I ever really had a difficult case where an insider or someone with information asked, "May we buy or may we sell," because when it does come up and someone is conscientious and there is a question, you either abstain or you disclose, if they are fortunate enough to have reflected on it.

If they're greedy or they don't care or they think they can get away with it, then they deserve to be pursued.

Senator RIEGLE. I want to go to Senator Bond unless one of your colleagues here has just a compelling need to comment.

Mr. COX. I was going to add the same thing. These cases are not "Oh, my gosh, I have inside traded." They are not "whoops" type cases. Particularly the misappropriation cases are evidence of scheme and design and intent.

Senator RIEGLE. Senator Bond.

Senator BOND. Thank you, Mr. Chairman.

Professor Langevoort, you indicated that there ought to be wrongfulness test not limited to theft, but you're not really comfortable with the breach of duty, and I would have to say that I wondered whether that's an appropriate standard. But if you don't use that, what do you use?

Mr. LANGEVOORT. To me, the appropriate standard is whether the information in question is reasonably subject to an expectation of confidentiality. That, by the way, is the way the legislation that was adopted in Great Britain in 1985 formulates the standard that we are debating here today.

The question of duty—whether somebody is subject to a relationship of trust and confidence—is one where you can find thousands of common law cases struggling with the issue. Usually, it takes some sort of assent by the person to an expectation of confidentiality before we say that they're subject to fiduciary duty. And there are too many cases where a person or an institution is given information subject to an expectation of confidentiality, but they haven't assented to any obligation. To say that they can go off and use it I find somewhat bothersome.

Let me give you an example, just to clarify my suggestion—trading by the issuer itself. In the last 6 weeks a number of firms have gone back into the marketplace to buy their own shares as a result of the fall in the stock market on October 19. I think we would say that if any of those companies—the issuers themselves—were in possession of material nonpublic information, it would be troublesome. I think it would threaten the confidence that we have in the marketplace.

Yet to say that an issuer has a relationship of trust or confidence or a fiduciary relationship to its shareholders is an odd concept. As a litigator, if I had this statute in front of me, I would have the opportunity to raise questions about the statute's meaning.

I think the concept of expectation of confidentiality is a slightly broader one, and tends to encompasss the kinds of situations that we have been concerned about.

Senator BOND. Does that get at the analyst, though, the guy who puts together the mosaic, the Dirks that comes and says, "Eureka, I've put it all together"?

QUESTIONS OF TIPPEE LIABILITY

Mr. LANGEVOORT. I find questions of tippee liability—essentially, an investment analyst is somebody who's received information on the corporation—very difficult to handle under a concept of duty. I find the wrongfulness concept useful because in the situation

where the insider has communicated information to the analyst under the type of detailed questioning that Mr. Bialkin described—where it appears that the insider is trying to communicate information in order to make information to the public available—that doesn't meet the standard of wrongfulness.

On the other hand, there have been a number of cases—including some very notorious ones in the last decade—where insiders have talked to analysts who have been favoring the company in the past or who have been saying nice things about the company to their shareholders, and have said, "You're our favorites; here's some inside information." Again, I think the wrongfulness concept is useful there because it says that that's wrong. It's not the sort of thing I would want to see legitimated by this legislation or any Commission rule-making.

The specific answer to your question is that I would deal with the liability of true insiders under a standard that emphasizes the presence of a reasonable expectation of confidentiality. I would deal with all tippee liability questions by turning to the antitipping provision that is separately written into S. 1380 and the reconciliation draft, which says it is unlawful to communicate information where a foreseeable effect is trading. I would simply make anybody who receives and uses information, knowing or recklessly disregarding that it was a violation of the antitipping provision, liable themselves. That's how I would take care of the tipping.

Senator BOND. Professor Cox, I expressed earlier my confusion over the difference between 16(a) and 20(a) on the derivative liability for a controlling person. Can you help me out? Which way would you go?

Mr. COX. I have a lot of problems with that, too, Senator. What I'm troubled about is primarily the inability to sort of flush out what's behind trying to rein in to some extent the employer's responsibility here.

I sense that what they were trying to do was to carry forward, unlike what the Chairman of the SEC was saying—I believe they were trying to carry forward the learning of 20(a) responsibility as it applies to brokerage houses. When we just look at the statute, 20(a) in the 1934 Act, it has a good faith term in it and that term in the case law has taken on a unique interpretation as it applies to brokerage houses, so that the brokerage house is able to satisfy the good faith requirement if it has a reasonably designed and systematic way of trying to detect whether there's wrongdoing going on in the house.

That defense is not in existence when we talk about just the regular corporation being responsible for misleading press releases of its chief financial officer. There, the question is not one of whether there's a reasonably designed detection method. It's a question of scienter or knowledge, et cetera.

So what I think that we're actually trying to do with this provision is to summarize very quickly and too hurriedly the case law applying to brokerage houses, but it leaves completely up in the air the question of what level of participation we're talking about to make one a controlling person.

So I find it a hopeless morass. Then, as I mentioned to you earlier, Senator, I am real troubled that this doesn't even reach the con-

duct of tipping, which is where the real problems are for I think investment analysts, passing on information, not receiving it, but brokers and analysts passing it on to others. There is no clear employer responsibility for wrongful tipping in either one of these two bills.

Senator BOND. Would you eliminate the 16(a) provision?

Mr. COX. Yes. My preference would be that the legislation should have a focus of legitimizing the misappropriation theory for enforcement purposes. I would not like to see this legislation become exclusive because I think one thing you do there is you throw out the window 20 years of cases, hundreds of cases, which have fleshed out the concerns that others have raised about materiality, what do we mean by "in possession", what do we mean by "an insider". We should not lightly throw that aside, particularly when you find that the history of the securities laws is broadly remedial and that the rights are cumulative. So I would throw out all references here to control person responsibility, allow the control person provisions of 20(a) to carry forward, along with the unique line of cases that deal with the brokerage houses and respondeat superior liability. If this Senate doesn't believe in respondeat superior, don't single out insider trading. Do it across the board and abolish it. But I don't think you want to do that, and that is what I would carry forward.

Senator BOND. I have one quick question on Professor Langevoort's standard of reasonable expectation of confidentiality. Do you like that?

Mr. COX. I think it's quite workable. My concern is that we've got to anchor this in an objective standard and not something that's purely private. Along the way, I think we've got to be very concerned here with why the Federal securities laws are aimed at this problem. Certainly the Federal securities laws are not purely aimed at protecting employer expectations. They are aimed at protecting securities markets, investors, the aggregation of capital, and the legislative history should reflect that.

What that does is support the idea that these expectations cannot be waived by the employer and employee.

Senator BOND. Thank you, Mr. Chairman.

Senator RIEGLE. Thank you, Senator Bond.

Senator Hecht.

Senator HECHT. Thank you, Mr. Chairman.

Mr. Langevoort, you mentioned about confidence, how important this is. Let's look at the facts. After Boesky's affair was in the front page of the papers, the Wall Street Journal, the New York Times, every paper around the world, which was heralded as one of the worst scandals of all time, what happened to volume? It went up dramatically. We had the largest volume after that—in fact, there was too much euphoria in the marketplace, which means it didn't mean one iota. The people continued to buy stocks and they had confidence or else they wouldn't have been buying stock. But right after the Boesky affair—I don't say that he triggered the volume—but it certainly was not a deterrent to volume. Do you agree on that?

Mr. LANGEVOORT. In the short run, I doubt that you could say that any event regarding insider trading has an impact on investment.

CONCERN FOR THE TYPICAL INVESTORS

The people we're concerned about are the typical investors, not the ones who are actively trading in the marketplace on a day-by-day basis. They're going to trade anyway. We're talking about the long-term buy and hold investor, the one who provides the liquidity in the marketplace—a liquidity that I think the events of the last couple of months point out is quite important. Those are not people who immediately react to events, positive or negative.

What we're talking about is a timeframe of a couple of years, or maybe a decade. If the perception becomes part of the culture of America that insider trading is the way you win in the stock market, I'm afraid those long-term investors—the people whose trading decisions don't show up every day—are the people we might lose.

Senator HECHT. Well, we have a difference of opinion on that.

Mr. Bialkin, you touched the No. 1 point that I've had on my mind. We do not want to prohibit new financing, new underwriting.

Now these underwriting firms, I don't know how many days sometimes they listen to this pitch from this group and this pitch from this group, we're going to do, we're going to do that, or we're going to bring this person into it, we're going to take over this company and we're going to be another General Motors, but they're the ones that have to underwrite. So they are given all this information. We cannot stop—and you brought that out more eloquently than I am talking—but we cannot stop that type of transaction in Wall Street.

Do you want to add anything? Because if we start making everyone scared to say anything or scared to say we've got a new product, we've got a new battery that's better than any battery in the world and we're going to market it, and the underwriter hears a pitch and then they send it out to their people, this is what concerns me, that we're going to stop what Wall Street has done so well for so long.

Mr. BIALKIN. I would agree with that. I would just supplement Professor Langevoort's statement, with which I don't disagree, by simply saying this. I don't know and I don't think anybody else knows really how insider trading affects markets. No one knows whether it really does.

However, I think for a free society, a society of notions of equality, it's unacceptable that a marketplace exists which doesn't outlaw and prohibit it in the sense of maintaining the integrity of the marketplace. It's not important to measure whether insider trading does or does not have a material dollar impact. There are some very respected people who suggest that insider trading has a salutary effect on the marketplace because it enhances the efficient market theory of events. I don't happen to subscribe to that.

I subscribe to the concept that you outlaw it and y prohi it and you police it simply because you want a market—

dollar impact—that has a reputation for honesty and integrity and fairness. The whole issue is how you come about it.

I don't think we should be forced to assume a quantum analysis because to me it's less quantum and more quality that we're interested in, the quality of the marketplace, and the question that you have to consider is whether the balance of legislative imperatives are being served or not served by the particular provisions.

We have raised no criticism at all about the definition of wrongfulness and possession, but we think the fundamental thrust in terms of what it is you're concerned about here is entirely healthy. Our concerns have to do with the technical workouts and the potential impact on people trading and the freedom of choice and activity in the marketplace. We simply urge you to reconsider in the light of these other comments.

CRIMINAL INTENT

Senator HECHT. To oversimplify something, no one has mentioned intent today. I think that should be considered because these people that we're talking about, every case that I knew anything about, they had criminal intent. They wanted to go out and conspire. Now they're criminals.

Now it's very, very hard to legislate against a criminal who goes out to conspire. I think we've got to differentiate who has criminal intent and who, by acts pursuant with their underwriting, may have put information out.

Do you agree on that?

Mr. BIALKIN. I do, sir. I think the statute passes the issue of intent by relying on the concept of wrongfulness, and we haven't analyzed that, but I personally believe wrongfulness implies an element of intent, scienter. That is, if something is wrongful and the person knows, this statute requires that he knows that that's the case, it's not the precise specificity of requirement of intent, but it's close enough so as not to give me any problem.

Senator HECHT. Mr. Chairman, this is a very, very important issue and I would like to ask that after you are all ready and you have legislation prepared, rather than rush, give us 2, 3 or 4 weeks so that we can take this particular legislation and pass it out to panels such as this and just see what the final product is. We are dealing with the very heart of America right now with our industrial worth of America. There's been 13 million new jobs created in the last 8 years, mostly by small companies who have been able to go in and on a sales pitch hit an underwriter and were able to continue. We don't want to stop that.

I think there are a lot of pitfalls, a lot of ditches we want to avoid on this. I think we should proceed very, very slowly, and when we do come up with the legislation that we're going to be asked to vote on, I would like to have all the best brains I can get together before I act on that.

Senator RIEGLE. Well, let me say to the Senator that what we have done here is to proceed in exactly that fashion. We have gone out, I might say exhaustively, because these are very complex areas of law and we've asked the chief practitioners to involve themselves now over a period of several months, systematically

step-by-step, concept-by-concept, case-by-case, so there has been, I daresay, thousands of hours of effort that have been now invested by the witnesses at the table and a very large additional group of people. That work has led to the various proposals and the adjustments in the proposals that we have seen.

So I think we have all approached this area with the same sense of care and sensitivity that the Senator speaks about in terms of the importance of understanding precisely what we're doing and having a thorough debate. We haven't finished it by any means and we're continuing today. I don't know that there's been a time in recent history where this area of law has been as exhaustively examined and debated and argued as we have been doing now over a period, as I say, of several months. We are not finished. We are going to continue with that same microscopic attention to these questions.

Now that doesn't mean in the end that everybody is going to see this exactly the same way. I have found, not being a securities lawyer, that securities lawyers are quite capable of seeing the same situation in a very different way. There are differences of opinion. One of the things that I'm learning is the fact that we will never precisely have everybody in absolute lineup of agreement here.

But I do think we are close to a growing consensus, albeit with some differences of opinion. But we're not going to rush to complete that process and I feel very strongly every member of the subcommittee and the full committee should be abreast of what is happening, to be able to participate in this discussion, to see what we have, to digest it, and to take it back out and talk to people before we come in and actually vote on it.

I feel as strongly about preserving the carefulness and the integrity of that process as does the Senator.

Senator HECHT. I thank you very much.

Senator RIEGLE. I want to thank the witnesses today. I think we've built a good, strong hearing record and we are most appreciative.

The committee is in recess.

[Whereupon, at 12:30 p.m., the hearing was adjourned.]

[Additional material supplied for the record follows:]

[Response to written questions of Senator Riegle follows:]

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RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM
DONALD C. LANGEVOORT

December 23, 1987

The Honorable Donald W. Riegle, Chairman
Securities Subcommittee of the Committee on Banking,
Housing and Urban Affairs
United States Senate
Washington D.C. 20510

Dear Chairman Riegle:

I am pleased to respond to your letter of December 21, 1987, posing some additional questions regarding the appropriate legislative response to the problem of insider trading beyond that covered in my December 15 testimony. I have set forth my responses below in the order in which your questions were asked.

1. *Why prohibit insider trading?*

As I indicated in my prepared statement, I believe that insider trading is fundamentally incompatible with the concept of a free and open securities marketplace. While I realize that there is no empirical proof one way or the other on the question of whether capital formation in the United States would be adversely affected by a public perception that insider trading is prevalent, I am concerned that any increase in a level of public distrust of the markets -- whether because of insider trading, or volitility, or any other cause -- could in the long run have unfortunate consequences. Given that, and finding no convincing reason why insider trading should be permitted, I am convinced that a proscription is desirable.

In addition, there are two other reasons for prohibiting insider trading. Permitting such trading would create a serious conflict of interest for company executives with respect to public disclosure of material nonpublic information. Information otherwise ripe for disclosure might be withheld to the extent that insiders believed that profit opportunities existed so long as the information remained undisclosed. That would be contrary to the full disclosure philosophy of federal securities regulation. Moreover, insider trading profits represent compensation received as a result of employment with the issuer, yet is not disclosed to shareholders the way other forms of remuneration are. This, too, is contrary to the full disclosure standard.

2. ***Factual Scenarios.***

(a) *The standard for tipper liability.* I agree with the reconciliation draft that tipping should expressly be prohibited under a standard that makes it unlawful wrongfully to communicate information where trading is reasonably foreseeable. As I indicated in my testimony, I believe that the wrongfulness concept should speak in terms of communication of information that is subject to a reasonable expectation of confidentiality, rather than requiring a finding of a breach of a fiduciary-like duty. Under this standard, a person who facilitates tippee trading by communicating confidential information other than in a good faith effort to publicize it would be held liable.

(b) *The standard for tippee liability.* I feel strongly that the standard for tippee liability should mirror the anti-tipping prohibition, rather than be part of the trading proscription applicable to true insiders. Thus, I would make it unlawful for any person to trade while in possession of information if that person knows (or is reckless in disregarding) that it has been communicated in violation of the anti-tipping prohibition. This simple revision would eliminate many of the difficulties now in the bill with respect to determining when tippee trading constitutes an indirect breach of a duty of loyalty.

(c) *Institutional liability: trading for its own account.* An institution should be liable when one or more of its employees or agents causes it to purchase or sell securities and that employee or agent possesses material nonpublic information that is subject to the trading proscription (i.e., the use of which would be considered wrongful). I do not believe that the question of liability should vary depending on whether the person causing the trades was a high level official, or on whether the institution had taken steps to caution its employees against insider trading. The fact that it was the purchaser or seller should be determinative.

When the employee or agent possessing the material information did not cause or otherwise influence the trade (and the burden of proof should be on the institution on this issue) I consider liability inappropriate. The fact that the institution did not have an adequate Chinese Wall seems insufficient to impose the sorts of penalties that true insider trading warrants.

I do believe that the legislation should add a new subsection to section 21 of the Securities Exchange Act to

require controlling persons to take such precautionary and supervisory procedures as are reasonable under the circumstances to prevent unlawful insider trading (Alternatively, or in addition, the Commission could be given rulemaking authority to establish such standards). Presumably, a failure to have a reasonable Chinese Wall would contravene such a provision. However enforcement of this sort of rule should be via injunctive relief only -- requiring appropriate corrective measures not civil penalites, disgorgement or criminal sanctions.

(d) *Institutional liability: trading by employees.* When an employee trades outside the scope of his employment, without any intention to benefit his employer, employer liability is inappropriate. As noted above, a firm that has not taken reasonable steps to prevent insider trading by its employees should be held to violate a separate statutory duty, and thus be subject to injunctive or other equitable relief. However, it should not be held liable for the trading itself.

I believe that where a firm puts an employee in a position to defraud a client or customer the firm should be responsible for any actual injury caused to the client or customer, including injury by insider trading or tipping, without regard to whether the individual wrongdoer intended to benefit his employer. However I consider this liability issue a matter properly for state law; it should be enough to indicate in the legislative history that such state law remedies are not preempted by this legislation.

e) *Institutional tipping.* Tipping by an employee within the scope of his authority (e.g., a tip by a stockbroker to impress a valued client of the firm) should lead to institutional liability. However, where the tip is solely for the employee's own benefit (e.g., telling a friend or relative), then liability is inappropriate.

(f) *Institutions as recipients of information.* The institution should be liable for any trading for its own account when (1 it is an insider (e.g. an investment banking or law firm with respect to trading in its clients' securities) or (2) any of its employees or agents are in possession of information that is subject to the trading proscription (either because they are insiders or tippees) and such employees or agents cause the trades in question (see response to item 2(c) *supra*).

3. *Defining materiality.* Mr. Bialkin made two separate suggestions along these lines. One is to define

material information in terms of information that, if disclosed, would be likely to have a substantial impact on the market price of the securities. Although I am unsure how much of a difference this represents over current law, I find it an appealing suggestion. To me, the essence of insider trading is trading with an expectation of such a subsequent market impact. Mr. Bialkin's proposal -- which is drawn from the American Law Instituts's proposed Federal Securities Code and its standard of a "fact of special significance" -- would simply tie the law to that notion. Such a definition might be of assistance in making clear that the great bulk of information received from company sources by investment analysts is not subject to the trading proscription.

On the other hand, I strongly disagree with Mr. Bialkin's suggestion that the legislation distinguish between issuer and "market" information. I consider liability appropriats whenever a person *wrongfully* takes advantage of information that, when disclosed, would be likely to affect the price of the issuer's securities, regardless of its source or nature. If there is a problem with the coverage of the law, it should be addressed in the section on liability itself, not through a strained -- and ultimately illusory -- distinction between types of plainly relevant information.

I hope that these responses have been useful. If I can be of any further assistance to the Subcommittse as the drafting process continues, please let me know.

Sincerely,

Donald C. Langevoort

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM
JAMES D. COX

Please consider this my response to the questions submitted to me by Senator Riegle in his letter of December 21, 1987. I have attempted to be brief in my response, even though the questions can each entail a lengthier response. I trust this will be useful to you and your staff.

1. What purpose is served by proscribing insider trading?

My testimony to the Subcommittee on December 15, 1987 opens with the statement that Carpenter v. U.S. makes the express statutory proscription of insider trading imperative. It is my belief that the ambiguity in the Supreme Court's even division in Carpenter will interdict the government's enforcement and deterrence efforts. Uncertainty as to the future viability of the misappropriation theory erodes the assurance that misconduct will be successfully prosecuted. When prosecuted, defendants will trade the uncertainty created by Carpenter for a lighter sanction because the enforcment personnel have justifiable fears that any enforcement predicated upon a theory of misappropriation will, after Carpenter, not withstand appellate review.

Insider trading is not socially or economically useful. See, Cox, Insider Trading and Contracting: A Critical Response To The "Chicago School," 1986 Duke L. J. 628, 642-55. Moreover, insider trading causes a good deal of harm. As stated in my testimony to the Subcommittee, there is growing evidence that insider trading accompanies abusive disclosure practices in which corporate personnel or market professionals delay or otherwise make false disclosures for the purpose of increasing their insider trading profits. Two such cases are In re Orfa Sec. Lit., [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶93,225 (D.N.J. 1987) and Froid v. Berger, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶93,201 (D.N.J. 1986). Even more troubling is that those in possession of inside information have manipulated real economic (corporate) events so as to maximize their insider trading profits. For example, Messrs. Boesky and Levine made massive purchases of FMC common stock to force its management to increase the consideration to be paid to the common stockholders in FMC's confidential restructuring plan. See FMC Corp. v. Boesky, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶

93,223 (N.D. Ill. 1987). In the face of evidence showing the connection of insider trading profits and manipulative conduct, it is a demonstrably sound regulatory response to not only proscribe the manipulative practices, but also to proscribe the insiders' trading profits which can be the insiders' or market professionals' incentive to manipulate disclosure practices, stock prices or economic events. Indeed, our proscription of insider trading can be justified as a necessary prophylaxis to remove the incentive corporate personnel, market professionals and others may have to engage in a wide array of abusive and manipulative practices. On this point, we are informed by the reasons offered by the Congress in 1934 when it made its first and most direct attempt to curb insider trading by enacting of section 16 of the Securities Exchange Act of 1934. The legislative history of that provision reflects that Congress was concerned that insider trading can lead to abusive and manipulative collateral practices. See S. Rep. No. 792, 73d Cong. 2d Sess 9. It therefore enacted the short-swing profit provision to remove one incentive for certain defined insiders to engage in manipulative practices.

There is also the pervasive concern among academics, businessmen and market professionals that insider trading erodes the integrity of American capial markets and thereby interdicts their allocational efficiency. The insider who trades has few defenders. Most individuals correctly view insider trading as harmful to the efficient flow of information to securities markets. While markets are not composed of players with the same endowments. For example, some have greater resources than others, the game becomes an unfair one when any participant plays with "loaded dice." A trader in possession of inside information plays with loaded dice. The number of participants in our capital markets would be significantly reduced if insider trading were legalized. With both investors and capital diverted to other activities, the cost of capital to American corporations would increase and a serious problem of resource allocation would arise. It should be emphasized that those discouraged by insider trading are not just the "small investor." Even market professionals are seriously threatened by insider trading. Consider, for example, that illegal insider trading profits in the AMAX case led to the failure of two options trading firms who had the misfortune to trade with the defendants in that case. See Longstreth, SEC Battle against Insider Trading Is Worth the Effort, Legal Times, May 10, 1982, at 16, col. 2. Furthermore, the direct or indirect approval of insider trading necessarily will lead to the ill effects of a Gresham's Law in which bad market practices drive out socially worthy market practices: the analyst whose views are available to the public will be replaced by the bribe paid for inside information which will then be available only to the few.

In sum, insider trading has little to commend itself and there are a good many reasons to believe and know that insider

trading is extremely harmful to the operation of our securities markets as well as American corporations.

2. Should a separate definition of "materiality" be included in any legislation proscribing insider trading ?

This is a bad idea. The first SEC insider trading prosecution occurred 27 years ago, Since that time a rich and thoughtful case law has developed which defines what is and what is not material information. It would be a serious mistake to throw that body of law out and replace it with a statutory definition of materiality. A statutory definition of materiality could never provide the certainty and wisdom of 27 years of litigation producing hundreds of decisions giving meaning and life to the meaning of materiality. Furthermore, a definition of materiality, no matter how well crafted, will certainly allow too many cases worthy of prosecution to "fall between the cracks."

In his testimony before the Subcommittee, Mr. Bialkin forcefully and unequivocally stated that advising clients on possible insider trading questions is among the easiest tasks a securities lawyer performs. I stated in my oral presentation to the Subcommittee that insider trading cases are not "whoops" cases; the insider is aware he is in possession of confidential information and is well aware that information is material and knowingly trades on the basis of that information. Accordingly, concerns of fairness do not even require that materiality be defined.

In sum, a statutory definition of materiality is not needed for clarity; such clarity is currently provided by a highly developed, informative case law. That case law does not reveal a single instance in which any insider trading case defendant has been disserved by the current case law definition of materiality.

3. Response to Tipping Hypotheticals:

Introduction: As I stated in my written submission to the Subcommittee as well as my oral presentation, tipping and tippee practices should be regulated in the same manner as approved by the Supreme Court in Dirks v. SEC, 463 U.S. 646 (1983). In Dirks, the Supreme Court held that a tippee and a tipper violate the antifraud rule only when a tip is improperly made. The Court narrowly defined when a tip is improper so that a tip is improper only when "the insider receives a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputational benefit that will translate into future earnings." Id. at 663 The sole exception to the requisite receipt of a pecuniary gain is when the tip is "to a trading relative or friend." Id. 664. Dirks embraces a clear and certain standard by which to resolve whether a tip and trading on a tip is unlawful. The wisdom of Dirks is its recognition that a less

certain a standard would be dysfunctional for the efficient operation of capital markets. Investment analysts deprived of a brightline standard defining unlawful tipping must proceed at their peril whenever their efforts yield from a corporate source new information. Certainly the dynamic that the securities laws ought to foster is the market professionals' aggressive pursuit of corporate information, confidential as well as public. To be sure, their pursuit should not be completely unregulated. The Supreme Court in Dirks wisely introduced a highly workable restraint on the analysts' pursuit of information: a pecuniary gain to the tipper. I believe that Dirks has served us well and commend its formulation to the Subcommittee.

I will now answer the tipping hypotheticals in the order in which they appear on your letter.

a). An individual who comes into possession of inside information does not personally use the information, but passes it along (a "tipper") to another person who then uses the information to trade securities (a "tippee"): When should the tipper be liable?

Consistent with the above introduction, I would hold the tipper liable if his tippee were a friend or relative or the tippee conferred upon the tipper a pecuniary gain. I believe it would be a rare case in which a tipper would ever deliberately relay to a tippee with knowledge that his tippee will trade. This kind of tipping would can be expected to occur, and generally has always occurred, only in cases in which the tip is circumscribed as being impropery under Dirks. It should also be remembered that corporations take great steps to preserve the confidentiality of their information and their employees are usually aware of their employer's concern. If there is no pecuniary gain and no tipping to a relative or friend, I believe the proper complainant would be the employer vis-a-vis its employee, but that action does not occur under the federal securities laws.

b). A tippee receives inside information from another person and trades securities on the basis of that information: When Should the tippee be liable ?

Consistent with the above introduction, the tippee should be liable only if he is a relative or friend of his tipper or the tippee is aware that he or another has conferred a direct or indirect pecuniary benefit upon the tippee as the "price" paid to obtaining the selective disclosure. This is a brightline test which assures certainty and, therefore, maximum deterrence.

c) An entity comes into possession of inside information and uses that information to trade securities: When should the institution be liable ?

The entity is in no different position than the individual

referred to in b) above. Each has knowingly traded "on the basis" of information secured from another. The liability of the entity is resolved in the same manner that it was for the individual in b): if not affiliated with the tipper, then it will be liable only if it is aware that one of the entity's employees or another has conferred a direct or indirect pecuniary benefit upon the tippee.

d). An employee of an institutiuon trades on inside information: When should the institution be liable?

There are two bases underwhich an institution can be held liable. One is the statutory controlling person provision of section 20(a) of the Securities Exchange Act of 1934. The second is under traditional agency law considerations, the most important being that of respondeat superior.

As a controlling person, the employer avoids liability if it can demonstrate its "good faith." Within the context of the securities laws, and especially as applied to brokerage houses, this defense is established whenever the brokerage house has maintained a reasonably designed program to deter and detect its employees unlawful tipping - trading practices. The advance sheets report instances in which brokerage firms have successfully established their "good faith" defense with a modestly designed and staffed securities law compliance programs.

An important feature of our common law heritage is the vicarious resonsibility of employers for the misbehavior of their employees committed within the scope of the employee's employment. This occurs under the doctrine of respondeat superior. The reasons for vicarious liability are well established both within and without the federal securities laws. Only the Ninth Circuit Court of Appeals has held there is no respondeat superior liability under the federal securities laws. It should be borne in mind that an entity will be liable under respondeat superior only if its employee tips or trades on a tip "within the scope of his employment." Thus, a tip or trade on a tip will expose an employer to vicarious responsibility only when its employing is acting on behalf of the employer.

As my prepared statement to the Subcommittee and oral testimony emphasized, the Congress should not retreat from either the present configuration of controlling person liability under section 20(a) of the Securities Exchange Act of 1934 or the application of respondeat superior liability. Indeed, there is no evidence in the advance sheets that either basis of liability has been imposed upon employers when their employees have engaged in unlawful tipping or trading. The reason for the dearth of control person or respondeat superior liability for tipping or insider trading is that those offense usually involves an employee's abuse of his position in that the employee invariably acts to reap a secret profit solely for himself. In sum, there is no reason for the there to be any change in the law on the

question of employer liability.

e). An entity that possesses inside information does not itself use that information to trade securities, but communicates the information to another person or entity, who then uses the information to trade securities: When should the entity be liable in this situation ?

The answer to this question is set forth in my answer to hypotheticals c) and d) above. In sum, it depends upon whether there was an improper tip ala Dirks and whether the entity can establish its "good faith" defense under the controlling person standard as well as that its "tipping employee" was acting outside the scope of his employment.

f). An entity receives insider information from another person and trades securities on the basis of that information: When should the entity be liable?

My response to this question is the same as that to question c). It should be emphasized that the information in this hypothetical must be material, that the trading defendant or its employees must know it was material and knowingly trade for the employer's account or otherwise within the scope of their employment trade while the themselves are in possession of said information.

This concludes my respone to the questions. I very much appreciate the opportunity to serve the Subcommittee and you. Please do not hesitate to give me a call if I can be of any further use; as life would have it, I am in Washington fairly frequently and I would be happy on such a trip to meet with you or your staff to be of whatever service I can.

Best regards,

Jim Cox

James D. Cox
Professor of Law

New York State Bar Association®

January 14, 1988

The Honorable Donald W. Riegle, Jr.
Chairman, Subcommittee on Securities
Law of the
Senate Committee on Banking, Housing
and Urban Affairs
SD-105 Dirksen Senate Office Bldg.
Washington, DC 20510

The Honorable Alfonse M. D'Amato
SD-520 Hart Senate Office Building
Washington, DC 20510-3202

Mr. David S. Ruder, Chairman
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: Proposed Insider Trading Legislation

Dear Sirs:

The Committee on Securities Regulation of the Banking, Corporation and Business Law Section of the New York State Bar Association (the "Committee") appreciates the opportunity to express its views with respect to the Securities and Exchange Commission's proposed legislation to define and prohibit insider trading.

The Committee is composed of members of the New York Bar practicing principally in the field of securities regulation, and includes lawyers in private practice, in corporate law departments, in law departments counseling certified public accounting firms, and other areas of practice. The views set forth in this letter are the views of the Committee and do not necessarily reflect the views of each of its members, the organizations with which its members are associated, the New York State Bar Association or its Banking, Corporation and Business Law Section.

NYSBA

The Honorable
Donald W. Riegle, Jr,
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Alfonse M. D'Amato and
The Honorable
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As you are aware, on July 20, 1987 the Committee commented by letter (a copy of which is enclosed) to Senator Riegle on S.1380, The Insider Trading Proscriptions Act of 1987, and the explanatory memorandum accompanying the proposed legislation. At that time the Committee made the following comment with respect to the need for the legislation:

> "As we wrote to the ad hoc committee, it is the view of the Committee that there is no pressing need for legislation either to define the elements of a violation based on the misuse of material nonpublic information or to reverse legislatively the results of recent federal circuit court and Supreme Court decisions. In particular, the Committee takes issue with the assertions in (and tone of the explanatory memorandum that there is currently such uncertainty and lack of clarity in the law that additional legislation is called for 'both as a matter of fundamental fairness to those who seek to conform their conduct to the law and to facilitate expeditious prosecutions when violations occur.' On the contrary, the Committee believes that the development of the law in this area by judicial decision, while not without some inconsistencies, has provided reasonably clear standards of conduct."

We also said:

> "Should the Supreme Court discard or severely limit application of the misappropriation theory in deciding [United States v Carpenter], there may be a need for legislation in this area. However, there is no reason presently to think that this will be the result. Accordingly, the Committee recommends against further efforts to pass S.1380 or any other proposed legislation seeking to codify the law of insider trading at this time.

On November 16, 1987 the Supreme Court decided Carpenter, affirming by a four to four vote the conviction for securities laws violations without expressing any views on the misappropriation theory and also affirming by an eight to zero vote the convictions for wire and mail fraud violations. Accordingly the law as stated in SEC v. Materia, 745 F. 2d 197, 203 (2d Cir. 1984), cert denied, 471 U.S. 1053 (1985) - "one who misappropriates nonpublic information in breach of a fiduciary duty and trades on that information violates Section 10(b) and Rule 10b-5" - remains the law for purposes of the government asserting a criminal or civil violation of the securities laws. Additionally, it is also clear that there is a criminal remedy under the federal mail and wire fraud statute for the misappropriation of material nonpublic

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information.

The Committee is still of the view that there is a reasonably clear set of standards in place dealing with the complex issues relating to the use of material non-public information in connection with the trading of publicly held securities. In the event that the misappropriation theory is in the future discarded or severely limited by the Supreme Court it may be necessary to codify standards considered appropriate at that time but the Committee is of the view that there are not significant benefits to be gained from the present legislative initiative. Consequently, the Committee reaffirms its recommendation against further efforts to codify the law of insider trading at this time and disagrees with the reasons proffered for its enactment

We are aware that there is still significant impetus for legislation in this area As we understand the situation, in addition to S.1380, and the Commission's proposal, there is a "Reconciliation Draft" of S 138 which is being proffered by some of the members of the "ad hoc committee" In the circumstances, it is possible that Congress may decide that legislation is appropriate at this time. Accordingly our comments are given in order to express our concerns with respect to various aspects of the Commission's proposal and to be helpful in shaping legislation (should Congress conclude that it is necessary) which will achieve the goals we outlined in our July 20 letter to Senator Riegle. We would appreciate the opportunity to consult with the Commission and Senator Riegle's staff as this fluid situation develops.

Comments:

1. In the first legislative finding, the bill makes reference to material nonpublic information relating to "an issuer of securities o a particular security or a group of securities". We suggest that the reference in the finding and elsewhere in the proposed legislation be solely to material nonpublic information relating to a secu ty The Committee acknowledges that industry specific information and information concerning markets can be material in certain circumstances but there s already a great deal of lucid discussion in the cases and elsewhere as to what constitutes mate ial information with respect to the purchase or sale of a security. Simply put, there is no need for this legislation to refer to anything other than material nonpublic information with respect to a security. All that is relevant is thus adequately covered To do more creates ambiguity by raising questions as to the possible intent of the legislation to expand on present notions of materiality.

2. There is considerable ambiguity in paragraph (b)(i) regarding the elements of culpability. For an insider, i.e., one

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who has not obtained information wrongfully, there must be "a wrongful use of such information" (emphasis added). Thus, for such a person, there must be possession plus use. On the other hand, for a tippee to be found to have violated the section, all that is required is for him to purchase or sell a security while in possession of such information. By effecting a purchase or sale, he is deemed to have used the information subject to any defense available under paragraph (b) 2 There seems to be no rationale for this distinction as to the elements of the violation; nor is there any discussion of it that we have come across f the legislation is to have a "possession" rathe than a "basis of" standard we suggest that the last clause of the first sentence of b) i be ewritten to read "or that such purchase or sale would constitute a wrongful use of such information, f based on such information " This will make t clear that possession, not use, will trigger the b)) offense in the case of an insider. However, the Committee suggests that a "basis of" test be reconsidered

3. The legislation incorporates an affirmative defense for persons other than natural persons who can establish that (i) the individuals trading did not know (and were not influenced by) the nonpublic information and (ii) the person (probably a financial institution) had in place reasonable procedures and policies designed to prevent the individuals making the investment decision from knowing the nonpublic information. The first prong of the defense is straightforward and appropriate. The second prong has become quite controversial. Of course, if the wrongful use of such information is determined to be a requisite element of the violation, the af rmative defense is not needed since there can be no violation without a demonstration that it was used in connection with the subject purchase o sale.

There s no doubt that the adoption by financial institutions of proper policies and procedures with respect to the handling of nonpublic information is desirable. In fact, the Committee's July 20, 1987 comment letter endorses including proof of the adoption of such policie and procedures as an appropriate element of the defense However the Committee is aware of the persistent and serious concern in the financial community that, if the current proposal becomes law, an ins tution will be held liable in situations where the inst tution is able to prove that the trading individual did not know the information but fa ls in sustaining the burden of proof as to the reasonableness of its policies and procedures Th s would be an unfortunate outcome to say the least in that the in titution would be held to have violated the Act, and be liable for civil and c iminal penalties even though there had been no "wrongful use" o material nonpublic information, but only guilt by association in that one person in the institution possessed material nonpublic information relating to a security while another person in the institution caused the

nstitution to trade in the security. In view of the unfairness of such an outcome, the Committee now recommends that the defense be limited to the first prong. In addition, as noted above, if the nstitution obtained the information rightfully, there must be shown under paragraph (b i to have been a "wrongful use." Thus, the defense is available by its terms only when the institution obtained the information wrongfully -- which we imagine should be the rarer rather than the more common occurrence.

As the second prong is now written in the Commission's proposal, the policies and procedures relate solely to the investment decision involved in the particular alleged violation, not policies and procedures with respect to nonpublic nformation generally. As a practical matter, it would be surprising if evidence o such policies and procedures were not proffered to he p establ sh the first prong of the defense in any trial with respect to an al eged violation of paragraph b). Indeed, most substantia financia nstitutions now have what most professionals functioning in this area consider to be reasonable policies and procedures designed to prevent individuals making investment decisions from possessing material nonpubl c information. Howeve the Committee is persuaded that it would be fundamentally unfair to subject an institution to liability inc uding possible treble damages) if the trading individual did not know and was not influenced by the material nonpublic information.

4. Many members of the Committee also feel that natural persons should have the opportunity to show that material nonpublic information in possession of such a person has not been used in connection with the purchase or sale of a secu ty f the person susta ns the burden o proof that the purchase or sale of the secur ty was not nfluenced by the information Some members of the Committee would go even further and suggest that it should constitute an affirmat ve defense if a natural person can prove that he or she had an independent basis for the purchase or sale of the security. The Committee suggests that such an approach be reconsidered.

5. As the Committee pointed out in the July 20, 1987 letter, the proscription on wrongful communication should be closely tailored to the proscription on wrongful rading We think that the draft egislation, although it s an improvement over S.1380, still needs further revision. The present proposal subsection (c of Section 6A provide that the proscription shall apply only to a person "whose own purchase or sale of a security would violate paragraph (b) of this section" - the proscription on wrongful trading.

Thus, the elements of the proscription on wrongful communication should to the extent feasible be the same as those

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relating to wrongful trading. Subsection (c) strays from this goal by introducing the element that, for a violation with respect to wrongful communication to exist, the offending pe son must know or recklessly disregard that the information communicated is "material and nonpublic." There is no such standard in the proscription on trading. Rather, one must know or recklessly d regard the "wrongfulness" of one's act. That should also be the standard with respect to communications.

We have rewritten the first sentence of subsection (c) so as to reflect the point mentioned above

> " t shall be unlawful for any person, directly o indirectly, wrongfully to communicate material nonpublic information relating to a security to any other person who, while in possession of such information, directly or indirectly purchases sel s or causes the purchase or sale of such security o communicates the information to another person who makes or causes such a purchase or sale while in possession of such information, if such person knows or recklessly disregards that such purchase or sale is reasonably foreseeable prior to the time when such information is no longer non-public."

We note that paragraph b contains an affirmative defense to the trading violation and inquire whether affirmative defense in a wrongful communication situation is appropriate. If so, we believe that paragraph (c) should be appropriately clarified. This should not be done by a cross-reference to the defense in subsection (b).

6. As a technical matter, the word "other" before the word "breach" in the definition of wrongful in each of subsections (b) and (c) is not cor ect As written, the definitions now read "conversion, misappropriation or any other breach of a fiduciary duty..." Conversion and misappropriation are not necessarily breaches of a fiduciary duty. Accordingly, the word "other" properly should be deleted.

7. Paragraph (d)(2)(B)(iv) should be rewritten as follows:

> "(iv) any person in possession of material nonpublic information relating to a tender offer which such person knows or recklessly disregards has been acquired directly or indirectly from any other person described in this paragraph (2)(B)."

This puts the "knowledge" standard in a position consistent with its position in the other paragraphs of the proposed

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legislation. As rewritten, knowledge pertains to the source of the information not whether it is material and nonpublic.

8. The Committee is disturbed by paragraph (g)(3) which is intended to make wrongful communicators under subsections (c) and (d) jointly and severally liable with wrongful traders.

The Committee s of the view that damages with respect to violations of the proposed legislation be imposed only on those committing trading violations and that wrongful communicators not be subject to such damages. The Committee is of this view primarily because of the potential chil ing effect of subsections (c) on those who are in the business of disseminating information about securitie e.g. analysts and financial newspapers but who themselves do not trade. Subsection c opens these persons to hindsight evaluation as to whether the receipt or communication of nformation would constitute a "breach of any personal or other relationship o trust and confidence" by the person who divulged the nformation to them This may not always be an easy analysis and proposed section 6A imposes draconian consequences for a good faith erro Moreove., one cannot but wonder what Raymond Dirks would have done had this legislation been enacted when he received that now famous information concerning Equity Funding.

In the alternative, the "tipper" or wrongful communicator should be liable only to the extent that it can be shown that the tipper" received value for making the communication which forms the basis of the violation. Although there may be concern as to the firmnes of the "value of the benefit" theory, the Committee believes that would be more palatable to have this standard as a measure of damages than the extremely harsh oint and several" standard which could mpose damages on a securities firm that would bankrupt it even though the firm comm tted no violation except to employ a person who caused the firm to purchase or sell a security on the basis of material nonpublic information and also tipped others who made much greate purchases and sales.

As to the enforcement and prevention functions of the legislation, the Committee points out that willful violations of the wrongful communication proscription wi constitute a felony. Vigorous enforcement in the criminal area seems to the Committee to provide at least as much deterrence as any measure of civil damages.

In the event that the joint and several standard remains, the Committee is concerned as to the extent to which this principle could be stretched and makes the following suggestions.

As written, a communication is a violation under subsection (c) only if the receiver of the communication or a person one level further removed trades on the basis of the information and

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such trade is reasonably foreseeable. However, the language in paragraph (g)(3) makes the communicator who violates subsection (c) jointly and severally liable with those who obtained profits or avoided losses, as a result of such violations. This may be read to extend to third, fourth and further removed levels of trade s if there is also a reasonably foreseeable trade at the first or second level since the trade at the fourth level is, in a strict analytical sense, the result of the original communication and will usually be as foreseeable as any othe trade This seems unintended. The paragraph should be rewritten to make it clear that the wrongful communicator is only jointly and severally liable with wrongful traders at the first and second level, if that is intended.

A still more serious problem exists with respect to communications that violate paragraph (d)(2). In such case the communicator violates the proscription not only in the case of a reasonably foreseeable trade at the first or second level, but at any level. Paragraph (g makes the communicator jointly and severally liable for all such trades no matter how remote. This should be cut back by mod fying paragraph (d)(2) to reflect the limits in paragraph (c) and by also modifying (g)(3) as suggested in the prior paragraph.

9. The Committee points out that the inclusion of the words "profit from" in subsection (c) may effectively eviscerate the defense intended to be provided by this section. Let us assume that an employee (an ndividual) of a financial institution violates paragraph (b)(1) by trading for such individual's account. The institution does not participate in or induce the acts which constitute the violation. Howeve the individual does use the fac ties of the financia nstitution to execute the trade and the inst tution does make it normal broke age commission (which includes a profit component) for execution. Under the proposed new language the institution would be liable. The Committee believes this to be unintended and accordingly suggests deletion of the words profits from. When the institution does profit in a meaningful sense from a trading violation, it will in fact itself be directly liable under subsection (b).

10. The legislation is intended to amend the Insider Trading Sanctions Act so as to make wrongful communicators as well as traders subject to the so-called "civil" penalties which may be sought by the Commission. The proposed language i not clear as to the maximum damages which may be sought against a wrongful communicator. It references three times the profit made or loss avoided as a result of the purchase or sales resu ting from such violation The Committee feels this should be cla fied to refer to the value of the benefit to the tipper or, if the Committee's comments in the third paragraph of number 8 above are not accepted, to the profit made or loss avoided by first and second level

traders. These are the amounts for which the communicator should be jointly and severally liable, if the bill is redrafted to reflect the comments in number 8.

11. The Committee is of the view that the prohibition in paragraph (d)(1) which now relates solely to tender offers may sensibly be expanded to cover statutory business combinations, sales of all or substantially all of the issuer's assets and purchases of a specified percentage of its secur ties fo instance 20% However, since this prong of the legislation s not based upon a wrongful act, the Committee is of the view that ts appl cation be crystal clear. Accordingly, the Committee is encouraged to see deleted in this proposal reference made in S.1 0 to acquisitions of a mate ial portion of an issuer's securities or its assets. Such a vague standard is inappropriate in the circumstances.

12. As to the Commission's proposals with respect to legislative history, the Committee will have to see the draft language prior to expr ssing views thereon. However as a general matter the Committee be eves tha the Commission should not be drafting language dealing with exemptions fo "persons whose information is obtained from source whose nexus to the securities industry is remote o insubstantia " It is d fficult to work through in the abstract a thoughtfully worded rule providing an exemption with respect to the misappropriation of materia nonpublic information from a sou ce lacking a significant relationship to the securities markets One would think the assayer's office in Kitts Creek Onta o would have little nexus with those markets but one can readily formulate the hypothetical case where theft of a report from such office would lead quickly to the type of mischief targeted by the Commission's proposed legislation.

The bi codifies present case law relating to misappropriation - or more to the point, theft - of material nonpublic information when such information is in the possession of a person trading secur ties or is communicated to a person who trades). Most agree this is the correct result. Further refinement at this stage is not necessary.

13. In clause (iii) of Subsection (d)(2)(A), the words "promulgated thereunder" are superfluous should be eliminated.

14. In paragraph (2) of Subsection (g) the words "may be" should be changed to "has been" since the Commission would presumably be free to bring an action under Section 21(d) of the Act, the Insider Trading Sanctions Act, n any case involving the wrongful use of material nonpublic information. It would be more appropriate, perhaps, to reduce the damages under Section 21(d) by the amount of civil damages that the person is potentially liable for.

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15. We suggest deleting subsection (g)(1)(B). It is essential that the measure of damages with respect to violations of this act be crystal clear The damages in subsection (g)(1)(B) are open-ended and cannot be calcula d with reference to trading activity. The damages provided by this subsection are an unnecessary additive to those otherwise provided by this legislation and consequently should be deleted.

16. We suggest changing the proposed legislation to clarify that it applies only to ecurities registered under Section 12 of the Securities Exchange Act and to securities of exempt insurance companies and investment companies.

17. In Section 3 Amendments to the Insider Trading Sanctions Act, we suggest that in the first of the two new sentences to be inse ted the words "and (ii) which i not part of a public offering by an issuer of securities other than standardized options" be deleted and, correlatively, the "(i)" on the th rd ne be deleted The reason for the inclusion of these word has never been entirely c ear and, in any event, the conc pt s redundant in that it does not appear that someone could a a practical matter, be he d to have violated Section 6A in any public offering by an issuer of securities other than standard ed options. In other words, the only relevant que on should be whether there has been wrongful use of material nonpublic information concerning a security.

18. Although most commentators feel that if new legislation is enacted to codify the law prohibiting the wrongful use of material nonpublic information Sections 16(a) and (b) of the Securities Exchange Act of 19 which provide fo the filing of reports of benefic al owne ship by officers, directors and 10% stockholders and the recapture of short-swing trading profits by such persons in order to prevent the possible unfair use of material nonpublic information, should be repealed and that the new legislation should become the exclusive remedy for insider trading violations. These section were enacted in 1934 as a part of the or ginal Securities Exchange Act which did not contain any other requirements for the reporting of holdings by of cers, directors and subs antial stockholders of corporations or for dealing with the unfair use of material nonpublic information by such persons.

The need for reporting by significant stockholders has been rendered redundant by the enactment of the Williams Act in 1968 which now requires the prompt filing of reports by beneficial owners of 5% of a class of equity securities. The reporting for executive officers and directors who are not also 5% stockholders is currently required for proxy statements involving the election of directors and certain registration statements. The Committee

believes that a better method of collecting and disseminating information about such trading would be to place the burden of doing so on the issuer.

More important, however, is the imposition of liability under Section 16(b) for short-swing profits made by officers, di ectors and 10% stockholders. This section in effect imposes a conclusive presumption that short-swing trading profits are based upon the unfair use of material nonpublic information by such persons However, it was enacted at a time when Congress did not have any other method of dealing with the unfair use of such information, and the enactment of the legislation now proposed would finally deal with this problem on a comprehensive basis. It was remarked dur ng the hearings on the 1934 Act that Section 16(b) is a "crude rule of thumb" and numerous cases have shown since then that most people caught under its provisions have violated t inadvertently, while there are also many examples of profits rea zed by large stockholders from short-swing purchases and sales that are exempt from its provisions. In the view of the Committee, if this legislation is enacted it would be appropriate to do away with Section 16(b) once and for all.

If this suggestion were to be accepted, Section 16(a) would also have to be amended in order to delete the filing requirements for beneficial owners of more than 10% of any class of any equity security. The material to be added as new Section 16A to the Act could instead be inserted in a new Section 16(b).

In the event we can be of any furthe assistance, please contact the undersigned at 425 Park Avenue, New York, New York 10022, telephone number (212) 836-8495.

Respectfully submitted,

COMMITTEE ON SECURITIES REGULATION:

Donald R. Adair	Richard T. McDermott
Margaret A. Bancroft	Orestes J. Mihaly
J. Truman Bidwell, Jr.	Sam S. Miller*
Charles H. B. Braisted	Vincent Monte-Sano
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Arne Hovdesven	Joseph L. Seiler III
Richard R. Howe	Lee B. Spencer, Jr.
James P. Jalil	Richard L. Veron
Richard D. Katcher	Gary W. Wolf
Michael P. Maloney	

By: Joseph D. Hansen
Joseph D. Hansen, Chairman

JH/er

*Mr. Miller does not join in the views expressed in this letter. Mr. Miller's views are expressed in the Statement of the Securities Industry Association to the Subcommittee on Securities, Committee on Banking, Housing and Urban Affairs, December 15, 1987.

BANKING, CORPORATION AND BUSINESS LAW SECTION

New York State Bar Association

July 20, 1987

The Honorable Donald W. Riegle, Jr.
Chairman, Subcommittee on Securities Law
of the Senate Committee on Banking, Housing, and
Urban Affairs
SD-105 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Riegle:

The Committee on Securities Regulation of the Banking, Corporation and Business Law Section of the New York State Bar Association (the "Committee") takes this opportunity to express its views with respect to S.1380, a bill to amend the Securities Exchange Act of 1934 to prohibit certain trading or communications by those who possess material, nonpublic information with respect to a security, introduced in the Senate of the United States on June 17, 1987 ("The Insider Trading Proscriptions Act of 1987").

The Committee is composed of members of the New York Bar practicing principally in the field of securities regulation. The Committee includes lawyers in private practice, in corporation law departments and in other areas. The views set forth in this letter are the views of the Committee and do not necessarily reflect the views of the organizations with which its members are associated, the New York State Bar Association or its Banking, Corporation and Business Law Section. The views of the Committee set forth in this letter are not necessarily the views of each member of the Committee.

It is our understanding that S.1380 (together with an explanatory memorandum) is the final recommendation of a group of securities law practitioners who, at your suggestion on February 24,

1987, formed an ad hoc committee to draft legislation defining and prohibiting insider trading activity. The ad hoc committee prepared a draft of such legislation and a draft explanatory memorandum, which were circulated for comments among securities practitioners and other parties including the Committee. The Committee met several times to discuss the proposed legislation and memorandum and sent the ad hoc committee written comments on the proposed legislation on May 20, 1987.

As we wrote to the ad hoc committee, it is the view of the Committee that there is no pressing need for legislation either to define the elements of a violation based on the misuse of material, nonpublic information or to reverse legislatively the results of recent federal circuit court and Supreme Court decisions. In particular the Committee takes issue with the assertions in (and tone of) the explanatory memorandum that there is currently such uncertainty and lack of clarity in the law that additional legislation is called for "both as a matter of fundamental fairness to those who seek to conform their conduct to the law and to facilitate expeditious prosecutions when violations occur." On the contrary, the Committee believes that the development of the law in this area by judicial decision, while not without some inconsistencies, has provided reasonably clear standards of conduct.

The Committee is of the view that S.1380 would primarily codify the results of recent cases. In particular, the proposed legislation would codify the reasoning of the Supreme Court in _United States v. Chiarella_, 445 U.S. 222 (1980), that a violation of the securities laws premised on the use of an informational advantage must also have as an element a breach of duty. It would also codify the misappropriation theory which has been adopted by a number of federal circuit courts in dealing with alleged insider trading violations subsequent to _Chiarella_. As you are aware, the misappropriation theory expands upon the breach of duty element required by _Chiarella_ by providing that the duty breached need not be a breach owed to a trading partner, but may be a breach of duty owed to a third party not to use information obtained from such party to facilitate a purchase or sale of a security. The Supreme Court has recently decided to review the application of the misappropriation theory by the federal circuit court in _United States v. Carpenter_, 791 F.2d 1024 (2d Cir.), _cert. granted_, 107 S. Ct.

666 (1986). We understand that the case will be argued this fall and probably decided late next spring.

Additionally, the Committee notes that recent in der trading cases involving prominent Wall Street figures fo instance Boesky Levine and Siegel) have not been based upon stretched" or novel legal theor es and that the defendants have not alleged that the law was unce ta n Expe ienced practitione s n th s area would have given such claims l tle credence had they been made There is little doubt as to the state of the law appl cable to recent highly publicized insider trading activities.

Should the Supreme Court discard or severely limit application of the misappropriation theory in deciding Carpenter, there may be a need for legislation in this area. However, there is no reason presently to think that this will be the result. Accordingly, the Committee recommends against further efforts to pass S.1380 or any other proposed legislation seeking to codify the law of insider trading at this time.

The Committee is aware that its view in this regard is not shared by some and that the publicity surrounding the prosecutions referred to above has led to pressure for legislative initiative. Also, the Committee believes that if Congress concludes that there is a need for new legislation in this area, such legislation should achieve the objectives of establishing a sound theoretical basis for insider trading violations and defining the violations so as to provide clear guidance as to proper conduct. Accordingly, the Committee encloses herewith our comments on S.1380. For your use, we have enclosed a redraft of S.1380 marked to show our suggested changes.

Summary:

The Committee believes that any legislation in this area should have as its focus a well thought out definition of proscribed conduct - both with respect to trading activity and the communication of material, nonpublic information. Comments No. 1, 2 and 3 deal with this issue. The Committee also believes a financial institution should have the ability to rebut the presumption of use of material, nonpublic information in connection with a purchase or sale of a security. However, the Committee does

not believe individuals need this ability if the insider trading violation is properly defined. Comments No. 4 and 5 deal with this issue The Committee does not bel eve that the proposed legislation's provisions with respect to the tipping of information concerning a planned acquisition or disposition by a "transacting party" are the correct approach to the problem of merger and acquisition trading abuses or a meaningful eplacement of Rule 14e-3. Comment No. 6 explains the Commi tee s position in this respect Comments No 7 and 8 set out the Committee's suggestions with respect to the Commission's rulemak ng author ty and private rights of action to redress violations of the section respectively. Addit onal comments of a technical or very specific nature are also given. Fin y, the Committee suggests that if this legislation is enacted into law, Sections 16(a) and (b) of the Securities Exchange Act of 1934 be repealed.

<u>Comments on Legislation</u>:

1. The Committee suggests inserting the words "information such person knows or has reason to know is both material and nonpublic" in lieu of the words "material nonpublic" in subsection (b)(1) (line 4, page 3), and also substituting the words "or has reason to know" for the words "or is reckless in not knowing" in subsection (b)(1) (line 10, page 3). The Committee believes that the appropriate elements of the trading violation are that (i) the trader knew (or had reason to know) that the information was material and nonpublic and (ii) that it was obtained wrongfully, or its use would be wrongful. As drafted, the bill contains no knowledge requirement with respect to the quality of the information (material and nonpublic) and the standard of recklessness is applied to the test of wrongfulness. The Committee also points out that page 9 of the explanatory memorandum is in conflict with S.1380 as drafted as it states that the knowledge standard applies to the quality of the information.

2. As a general matter, the Committee expresses its strong view that to be at all effective the legislation must define clearly the term wrongful, <u>which it does</u> as drafted. The Committee has reviewed the testimony of Commissioner Charles C. Cox before the Subcommittee on June 19, 1987 and notes his concern that a definition of wrongful, limited by the word "only" to the conduct referred to in subsection (b)(1), could reduce Commission

flexibility in bringing further enforcement actions. Perhaps it may. It should. As the Committee has previously indicated, it believes the present state of the law to be clear - "one who misappropriates nonpubl c in ormation in breach of a fiduciary duty and trades on that information violates Section 10(b) and Rule 10b-5." SEC v. Materia, 7 5 F.2d 197,203 (2d, Cir.1984), cert. denied, 471 U S. 1053 (1985). The Committee views the purpose of S.1380 to be legislative codification of this rule. S.1380 accomplishes this purpose. To proscribe "wrongful" use or communication of information without defining wrongful will certainly create uncertainty regarding standards of conduct in this area. Such uncertainty can not be justified on the basis of insuring enforcement flexibility. The Committee would strongly oppose any legislative proposal in this area which does not contain a clear definition of the term wrongful. In the Committee's view, if the Commission is not prepared to support such a definition, there should be no further attempts to adopt legislation in this area.

3. The Committee had difficulty understanding the exact scope of the "tipper" provision of subsection (c)(1) and could not reconcile it with the description in the accompanying memorandum. The memorandum on page 10 states "On the other hand, wh n proceed ng against a tipper, it is clear that, in addition o the elements of tipper liability, a to the tippee, the government must establish simply that he or she traded afte receiving the information; this provision would not require the government to prove that the tippee knew that the communication, and therefore his trade, was wrongful, to sustain the action against the tipper." However, subsection (c)(1) states that the tipper must know (or be reckless in not knowing) that the information would be used for a purchase or sale that would violate subsection (b) of this section. As noted, subsection (b) requires the tippee to know (or be reckless in not knowing) that the information was wrongfully communicated. Consequently, as drafted, the legislation would require the government to establish knowledge of wrongfulness on the part of the tippee. In any event, the Committee believes that the elements of the "tipper" offense should be as clearly stated as those involving illegal trading. S.1380 does not accomplish this goal. In fact, wrongful communication is proscribed but the term wrongful is not defined. For the reasons set forth in No. 2 above, the Committee believes this would be

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a serious legislative error. The Committee believes that the elements of the offense should be (1) wrongful communication with wrongfu defined as a breach, as in subsection (b 1 2 nowledge that the informat on was mate al and nonpubl c and (3) a trade by the person receiving such information. The "tipper" off nse would then closely parallel the "tippee" (trading) offense.

4. The Committee generally agrees with the presumption of use of material, nonpublic information set out in subsection b)(2) and the limitation on rebuttal thereof to non-natural persons. (The Committee eads the pr sumption, as written, to be not rebuttable in the case of natural persons and disagrees with Commissioner Cox s view that a natural person cou d rebut the presumpt on) However, many members o he Commi tee feel that natural persons should have the opportunity to rebut the presumption that material nonpubl c information in possession of such a person has been used f the person sustains the burden of proo that the purchase or sale of the security was not in uenced by the information. Some members of the Committee would go even further and suggest that it should constitute an affirmative defense if a natural pe son can prove that he or she had an independent basis for the purchase or sale of the ecurity The Commi tee has based its acceptance of the presumpt on on the belief that the legislation will be redrafted to incorporate its comments in No. 1 above. If th s s the case, an individual would have to know that nformation n his (or her) possession is material and nonpublic and has been wrongfully obtained (or that i s use would be wrongful). If such is the case, the ability to rebut the presumption would be of smal utility and the disadvantage to enforcement would outweigh any reasons for including the ability of a natural person to rebut in S.1380. However, should the comments in No. 1 not be incorporated, the Committee would advocate that the ability to rebut the presumption be available to natural persons.

5. The Committee is also of the view that non-natural persons (for instance, financial institutions) should be able to rebut the presumption if they can show that the person causing the purchase or sale (or effecting it) did not know the information and that the institution had reasonable policies and procedures in place to prevent violations. As drafted, S.1380 requires proof that the purchase or sale was not influenced by the

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information and that the individual causing (or effecting) the purchase or sale did not know the information. This seems redundant. Also, S.1380 provides that the existence or la of pol cies and procedures to prevent violations should be considered relevant in determining whether the burden of proof involved in the rebuttal has been met. The Committee believes, as a general principle, that legislation as to what is relevant in a judicial proceeding is not effective and, in this particular instance, is inappropriate. The Committee is of the view that if a financial institution has not adopted reasonable policies and procedures to prevent violations in this area, it should not be entitled to rebut the presumption.

6. The Committee has substantial difficulty with subsection (c)(2 t s clearly intended that S.1308 be the exclusive prohibition relating to trading based upon, or the "tipping" of, material, nonpublic information and that Rule 10b-5 and Rule 14e-3 no longer be used in connection with "insider trading" cases. S.1308, excluding subsection (c)(2) and taking into account the comments in this letter, is an integrated sensible codification of present case law proscribing impermissible trading and tipping practices based on traditiona nsider t ding law and the misappropr ation theory Howeve., Rule 14e-3, relating to trading and tipping of nside information with respect to tender offers, prohibits certain trading practices and tipping of certain information even if there is no breach of a duty or relationship. It is not based on traditional insider trading law or misappropriation. Subsection (c)(2) is the ad hoc committee's attempt to codify Rule 14e-3 and make it superfluous.

The Committee's first objection to subsection (c)(2) is the uncertainty concerning the situations to which it is applicable. Unlike Rule 14e-3 which relates to tender offers (which, even in times of intense acquisition activity, will be a relatively small number of definable transactions), subsection (c)(2) relates to acquisitions or dispositions of an issuer an unclear no ion), or a material block of its securities or assets. These are certainly not precisely defined situations. While the Committee sympathizes with the concern many have over the potential for abusive trading practices in connection with merger and acquisition activity, it would seem that the prohibitions in subsection

(c)(2) could just as well have been drafted to cover any situation in which a person intends to enter into a material transaction (of any kind, such as a purchase of an extraordinary amount of inventory) with an issuer. In the Committee's view, such an expansion of "insider trading" laws is not called for. On the other hand, there is justification for legislation in this area if Rule 14e-3 is to be repealed. The Committee would select an acquisition of at least 15% of an issuer's securities as a reasonable benchmark for legislation of this type.

Additionally, the Committee notes that there is no prohibition on the purchase or sale of securities by a person who has been provided the information in violation of subsection (c)(2) or who has received the information in the course of a good faith solicitation to act on behalf of, or as part of a group with, the transacting person but has declined to so act. This creates a large "hole" in accomplishing the purpose of this subsection. In the Committee's view, it will be difficult to rebut a defendant's claim that information was passed for purposes of making a good faith solicitation. Consequently, if a person declining such a solicitation can still legally trade, the provisions of subsection (c)(2) may be ineffective. For this reason, the Committee is strongly of the view that if (c)(2) is to become the law, there is no reason not to also proscribe the act of trading on the basis of such material, nonpublic information. Although the Committee has reserva ions with respect to subsection (c)(2), it believes tha f redrafted to apply to certain well-defined events and if supplemented by a proscription on trading on the basis of such information (a new subsection (b)(3)) - which closes the loophole in the scheme provided by the good faith solicitation exception - (c)(2) will provide a reasonable impediment to certain unfair trading practices in connection with merger and acquisition situations.

7. The Committee feels that there is no need to limit the Commission's rule-making or exemptive authority to situations "consistent with the provisions of the section." This is either superfluous or assumes the Commission will not be able to function in this area with the same degree of propriety as it does in others within the scope of its authority. There is no need to channel its powers.

8. The Committee agrees that legislation of this nature should provide for a private right of action which will penalize a violator with a reasonable measure of damages. In order to so provide, the Committee feels that subsection (f) should be modified in several respects. In the first instance, subsection (f) should make clear that while contemporaneous purchasers or sellers may be deemed to have been damaged, others may also be able to prove injury and recover damages. Also, the damages for trading in violation of (b)(1) and (b)(3) should be measured by profits made or loss avoided. However, damages for tipping (subsections (c)(1) and (c)(2)) should be limited to the value of the benefit received for making the proscribed communication. Making the "tipper" jointly and severally liable with all the tippees, including remote levels of subsequent tippees, is a draconian remedy which, in the Committee's view, does little to further the purposes of the legislation. Finally, the Committee believes that damages provided for by statute should be collectible to the extent the violator is solvent and should not be reduced by the amount disgorged pursuant to section 21(d) of the title.

9. The Committee suggests deletion of references to material information relating to groups of securities and markets for securities in subsection (a)(1) (lines 7 and 8 on page 2). The Committee acknowledges that industry specific information and information concerning markets can be material in certain circumstances but there is already a great deal of lucid discussion in the cases and elsewhere as to what constitutes material information with respect to the purchase or sale of a security. Simply put, there is no need for this legislation to refer to anything other than material, nonpublic information with respect to a security. All that is relevant is thus adequately covered. To do more creates ambiguity by raising questions as to the possible intent of the legislation to expand on present notions of materiality.

10. The Committee suggests changing the word "misuse" to "use" in the 10th line (on page 2) of subsection (a)1. As is explained above, the "tipper" offense should be the wrongful communication of material, nonpublic information, coupled with a subsequent purchase or sale. Whether the subsequent purchase or sale is wrongful is irrelevant. For the same reasons, "misuse" should be changed to "use" in subsection (a)(2) (page 2, line 15).

11. To provide clear guidance in connection with statutory construction, the Committee suggests changing the words "is necessary to promote greater clarity in the law." to "and framing the rights of individuals damaged by a violation of this section is in the public interest." in subsection (a)(4).

12. As a technical drafting matter the words "duty or" should be inserted before the word "relationship" in subsection (b)(1) (line 18, page 2). Also, the word "section" (line 13, page 2) should be changed to subsection.

13. For the reasons given in comment No. 9 above, the words "(or the market therefor)" should be deleted from subsection (b)(2).

14. As a technical matter subsection (g) should be revised to read "This section shall provide the exclusive standards by which the use or communication of material, nonpublic information in connection with the purchase or sale of a security shall be addressed." This deletes the concept of wrongful which has been generally defined as a breach of a duty or relationship - and thus makes clear that subsections (b)(3) and (c)(2), which do not involve the concept of such a breach, are also intended to be exclusive.

<u>General</u>:

The Committee wishes to put in a word of caution with respect to formulation of the legislative history of any insider trader legislation. If members of the present Congress should go on record as concluding that the present law is vague and unclear with respect to insider trading, such statements might be taken into account by a court in later determining whether the present law is unconstitutionally vague with respect to alleged crimes relating to insider trading violations which may have been committed in the past. The rule of judicial construction which permits this analysis is known as the doctrine of subsequent legislative history. <u>Andrus</u> v. <u>Shell Oil</u>, 446 U.S. 657 (1980). Generally speaking, the Committee is of the view that the present law is not vague or unclear with respect to insider trading violations which have been alleged by the government in the past.

Finally, the Committee would respectfully

like to suggest that if this legislation is enacted, the Cong ess should repeal Sec ions 16(a) and (b) of the 1934 Act The e sections were enacted in 1934 as a part of the o iginal Secu ies Exchange Act which did not ontain any other requ rements for the reporting of holdings by officers directors and substantial stockholders of corporations or fo dealing with the unfair use of material nonpublic information by such persons.

The need for reporting has been rendered almost completely redundant by the enactment of the Williams Act in 1968 which now requires reports by beneficial owners of 5% of a class of equity securities. It is true that there is no other requirement for the filing of reports by officers and directors who aie not also 5% stockholders, but the utility of the repo ts being filed under Section 16(a) is questionabl and the volume of such reports is a substantial burden on the Commission. The Committee does feel that timely reports of trading officers and directors is important to the securities markets but would suggest that a better method of collecting and disseminating information about such trading would be to place the burden of doing so on the issuer.

More important, however, is the imposition of liability under Section 16(b) for short-swing profits made by officers, directors and 10% stockholders. This section in effect imposes a conclusive presumption that short-swing trading profits are based upon the unfair use of material nonpublic information by such persons. However, it was enacted at a time when Congress did not have any other method of dealing with the unfair use of such information, and the enactment of the legislation now proposed would finally deal with this problem on a comprehen ve bas . It was remarked during the hearings on the 1934 Act that Section 16(b) is a "crude rule of thumb" and numerous cases have shown since then that most people caught under its provisions have violated it inadvertently, while there are also many examples of profits realized by large stockholders from short-swing purchases and sales that are exempt from its provisions. Moreover, enforcement under Section 16(b) is limited to private actions brought in the name of the issuer which are not as effective as actions by the Commission. In the view of the Committee, if this legislation is enacted it would be appropriate to do away with Section 16(b) once and for all.

If you should wish to discuss any of our comments, please do not hesitate to call. If you wish, members of our Committee will meet with you to discuss your proposed legislation and our comments.

Respectfully submitted,

COMMITTEE ON SECURITIES REGULATION

By Joseph D. Hansen
Joseph D. Hansen, Chairman
(212) 836-8495

JH/er

encls.

A BILL

To amend the Securities Exchange Act of 1934 to prohibit certain trading or communications by those who possess material, nonpublic information.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Insider Trading Proscriptions Act of 1987".

SEC. 2. INSIDER TRADING PROSCRIPTIONS.

Chapter 78 of title 15, United States Code, is amended, by adding at the end of section 78p the following:

"§ 16A.

"(a) FINDINGS.--

"(1) The fairness, honesty, and integrity of the Nation's securities markets are impaired when corporate insiders and other persons who obtain material, nonpublic information relating to a security wrongfully use that information, or wrongfully communicate that information to others who use it, in connection with the purchase or sale of any security.

"(2) Effective prohibitions against trading by persons who wrongfully use material, nonpublic information, and wrongfully communicate that information to others who use it, are necessary to preserve the integrity of our markets and their ability to serve important national and international economic functions, including capital formation.

"(3) There is an important public interest in the prompt, unfettered flow to the securities markets of information.

"(4) The specific delineation of what constitutes the wrongful use or wrongful communication of material, nonpublic information and the framing of the rights of persons damaged by a violation of this section is in the public interest.

"(b) PROHIBITION AGAINST THE USE OF MATERIAL, NONPUBLIC INFORMATION.--

"(1) It shall be unlawful for any person,

directly or indirectly, to use information such person knows or has reason to know is both material and nonpublic to purchase or sell any security, by the use of any means or instrumentalities of interstate commerce, or of the mails, or of any facilities of any national securities exchange, or of any automated quotations system maintained for the trading of securities, if such person knows or has reason to know that such information has been obtained wrongfully, or if the purchase or sale of such security would constitute a wrongful use of such information. For the purposes of this subsection, information shall have been used or obtained wrongfully only if it has been obtained by, or its use would constitute, directly or indirectly, theft, conversion, misappropriation or a breach of any fiduciary, contractual, employment, personal or other duty or relationship of trust and confidence.

"(2) For purposes of subsection (b)(1), any person who purchases or sells a security while in possession of material, nonpublic information relating to that security shall be presumed to have used that information in connection with such purchase or sale. Notwithstanding the foregoing, in the case of a person other than a natural person, the presumption that such material, nonpublic information in that person's possession was used in connection with a purchase or sale of that security shall be overcome if such person sustains the burden of proving that--

"(A) the individual effecting the purchase or sale, or causing others to purchase or sell, on behalf of such person, did not know the material, nonpublic information; and

"(B) such person has implemented and maintained reasonable policies and procedures to prevent violations of this section by the individuals making or influencing investment decisions on its behalf.

"(3) It shall be unlawful for any person, directly or indirectly, to use information such person knows or has reason to know is both material and nonpublic with respect to a proposed acquisition or disposition of equity securities referred to in subsection (c)(2) to purchase or sell any securities of such class, by the use of any means or instrumentalities of interstate commerce, or of the mails, or of any facilities of any national securities exchange, or of any automated quotations system maintained for the trading of securities, if such person knows or has reason to know that such information has been communicated, directly or indirectly, to such person by a transacting person referred to in subsection (c)(2) for the purpose of encouraging the purchase or sale of securities of such class or if such information has been communicated in the course of a good faith solicitation of

such person to act on behalf of or as part of a group (within the meaning of section 13(d)(3) of this title) with the transacting person referred to in subsection (c)(2) and such person declines to so act.

"(c) PROHIBITIONS AGAINST THE WRONGFUL COMMUNICATION OF CERTAIN MATERIAL, NONPUBLIC INFORMATION.--

"(1) It shall be unlawful for any person, directly or indirectly, wrongfully to communicate information such person knows or has reason to know is both material and nonpublic to another person who, directly or indirectly, purchases or sells any security that is the subject of the communication, while in possession of such information. For purposes of this subsection, information shall have been communicated wrongfully only if its communication would constitute, directly or indirectly, theft, conversion or misappropriation or a breach of any fiduciary, contractual, employment, personal or other duty or relationship of trust and confidence.

"(2) It shall be unlawful for any person who has taken a substantial step or steps with respect to a proposed acquisition or disposition (whether by open market purchases or sales, a tender offer, a business combination, or otherwise) of the beneficial ownership of more than 15 per centum of the class of any equity security of an issuer or any person acting on behalf of or in concert with such person (the "transacting person"), for the purpose of encouraging the purchase or sale of the securities of such class, to communicate, directly or indirectly, material nonpublic information concerning such proposed acquisition or disposition to any other person who thereafter purchases or sells securities of such class, unless such other person is acting on behalf of or as part of a group (within the meaning of section 13(d)(3) of this title) with the transacting person or the communication of such information has been made in the course of a good faith solicitation of such other person to act on behalf of or as part of a group (within the meaning of section 13(d)(3) of this title) with the transacting person or the securities are acquired directly from or sold directly to the transacting person.

"(d) DERIVATIVE LIABILITY.-- No person shall be liable under this section solely by reason of the fact that such person controls or employes a person who has violated this section, if such controlling person or employer neither participated in, nor directly or indirectly induced, the acts constituting the violation of this section.

"(e) COMMISSION RULEMAKING AND ORDERS.-- The Commission may by rules, implement the provisions of this

section. The Commission, by rules, or by order, may exempt any person, security or transaction, or any class or classes of persons, securities or transactions, from any provision or provisions of this section.

"(f) PRIVATE RIGHTS OF ACTION.-- Any person who is injured by a violation of this section, whether or not such person is deemed to be injured by the next succeeding sentence of this subsection, in connection with the purchase or sale of any security may recover any damages sustained by reason of such violation. For the purpose of this section, a person shall be deemed to have been injured by a violation of this section if such person has purchased or sold the affected securities contemporaneously with the transactions in such securities that form the basis of the violation of subsection (b) or (c) of this section. No person shall be liable in damages in any action under this section for a violation of subsection (b) for an amount in excess of such person's actual profit obtained or loss avoided. No person shall be liable in damages in any action under this section for a violation of subsection (c) for an amount in excess of the value of the benefit such person received for making the communication which formed the basis of the violation of subsection (c). The period of limitations for the commencement of any action under this subsection shall be the same as that provided in section 21(d)(2)(D) of this title (the Insider Trading Sanctions Act).

"(g) EXCLUSIVITY.-- This section shall provide the exclusive standards by which the use or communication of material, nonpublic information in connection with the purchase or sale of a security shall be addressed. This section shall not, however, affect other prohibitions or requirements of law based, in whole or in part, on conduct other than such use or communication of material, nonpublic information.".

SEC. 3. EFFECTIVE DATE.

This Act shall take effect immediately upon enactment of this Act.

SUPPLEMENTAL

WRITTEN STATEMENT

OF

THE FINANCIAL ANALYSTS FEDERATION

FOR THE

SECURITIES SUBCOMMITTEE

OF THE

SENATE BANKING, HOUSING AND

URBAN AFFAIRS COMMITTEE

REGARDING

S. 1380

January 15, 1988

I. INTRODUCTION

The Financial Analysts Federation ("FAF") is pleased to submit this supplemental written presentation to the Securities Subcommittee of the Senate Banking, Housing and Urban Affairs Committee regarding S. 1380, the Insider Trading Proscriptions Act of 1987 ("S. 1380"), introduced by Senators Donald W. Riegle and Alfonse M. D'Amato on June 17, 1987. The FAF submitted its initial presentation on August 28, 1987 ("FAF Statement"), which considered S. 1380, the proposed legislative definition of insider trading submitted to the Subcommittee by the Securities and Exchange Commission in the form of "The Insider Trading Act of 1987", on August 3, 1987, and the proposed act submitted by the New York Stock Exchange ("NYSE Bill").[1]

Since August, the SEC has submitted a revised proposal dated November 18, 1987 ("SEC Bill"), and the authors of S. 1380 have also prepared a revised draft of S. 1380 in November 1987

1/ The Financial Analysts Federation, organized in 1947, is the professional organization for investment managers and securities analysts with 56 member societies and chapters in financial centers of the United States and Canada and with almost 16,000 individual members. The FAF's Statement is reprinted in the report entitled "Definition of Insider Trading, Hearing before the Subcommittee on Securities of the Committee on Banking, Housing and Urban Affairs United States Senate," Part II, August 7, 1987 (S. Hrg. 100-155, Pt. II), (the "Hearing Report"). The FAF's Statement appears at pages 106 to 123 of the Hearing Report which also contains the page numbers of the Statement. In this supplemental statement, page references to the FAF Statement are to the FAF Statement pages rather than the Hearing Report pages. The material in the FAF Statement on the FAF and its members appears at pages 2 and 31 to 36.

("Reconciliation Draft"). Testimony was received by the Subcommittee on the SEC Bill on December 15, 1987.

At the outset, the FAF notes that the circumstances surrounding the proposed legislation has changed significantly in the last two months. First, the Supreme Court in the Carpenter case has affirmed the criminal conviction of Foster Winans, the former Wall Street Journal columnist, on the wire and mail fraud counts, and by an evenly divided court on the securities law counts.[2] This seems to many commentators, including the FAF, to remove uncertainty concerning the legal basis for, and impediments to, the Securities and Exchange Commission's enforcement program against insider trading abuses. The SEC initially took the position in the Subcommittee's hearings that legislation was not necessary to the continued pursuit and success of the SEC's enforcement program absent an adverse decision in the Carpenter case.[3] While the SEC has now proposed two versions of its own Bill, it apparently still believes that legislation is not necessary.[4]

Even more troubling is the emergence of substantial concern, criticism and opposition to the SEC Bill and the Reconciliation

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2/ U.S. v. Carpenter, 56 U.S.L.W. 1073 (November 16, 1987), aff'g. (securities law counts by an equally divided court), 791 F.2d 1024 (2d Cir. 1986).

3/ Statements of Commissioner Charles C. Cox on June 19, 1987 and August 7, 1987, see also FAF Statement at 9 and 10.

4/ Statement of SEC Chairman David S. Ruder, December 15, 1987, at 1 and 2.

Draft of S. 1380.[5] The FAF shares much of this concern most of which, on the part of the FAF, was described in the FAF Statement. Moreover, it is also apparent from statements submitted at the December 15, 1987, hearing that the American Bar Association committee charged with studying and commenting on the proposed legislation has not finished its process nor has it reached agreement on recommendations.[6]

The FAF believes that it is highly desirable, and is hopeful, that as the legislative process continues it permits adequate time for important groups such as the ABA committee to complete its review process and that most concerned commenting organizations and committees reach a consensus that a proposed bill is in satisfactory form.

The participants in this legislative process are to be commended for their dedicated efforts to produce an acceptable bill. These include, among others, the Subcommittee and its staff, the SEC and its staff, and the Ad Hoc Legislative Committee to Define Insider Trading which prepared S. 1380 and the Reconciliation Draft ("Ad Hoc Committee"). The process has been fruitful in many respects but most certainly in identifying and considering the many important issues in this complex

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5/ See, for example, statements of December 15, 1987, by the Securities Industry Association, Kenneth J. Bialkin, Milton V. Freeman, and Richard B. Smith.

6/ See, for example, statements of December 15, 1987, by Kenneth J. Bialkin, and A. A. Sommer, Jr.

subject. The FAF believes, however, many of these issues remain unresolved in the SEC Bill and the Reconciliation Draft.

II. NEED FOR LEGISLATION

The FAF vigorously supports prohibitions against insider trading and the SEC's enforcement program.[7] It has long advocated regulatory and self-regulatory programs to prevent and prosecute insider trading abuses.[8] The FAF and its companion organization, the Institute of Chartered Financial Analysts, established 20 years ago, and enforce, a Code of Ethics and Standards of Professional Conduct which prohibit such conduct.[9] The FAF also responded to the SEC's 1973 request for guidelines on insider trading with an extensive set of guidelines and commentary.[10]

The FAF has carefully reviewed the history of the efforts to codify by statute or by regulation, prohibitions against insider trading. It has also studied the thoughtful and extensive commentary presented in the current legislative proceeding. And it has evaluated the need and desirability for a new statute on insider trading under the existing circumstances and state of the law.

The FAF concludes that, at present, there is no compelling need for legislation. In the opinion of the FAF, the SEC is a

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7/ FAF Statement at 3, 7, 31 and 32.

8/ FAF Statement at 7, 31 and 32.

9/ FAF Statement at 7, 33 and 34.

10/ FAF Statement at 21 and 32.

highly respected and efficient regulator. However, the SEC has not requested a statute, and except for the hiatus due to the recently pending Carpenter case before the Supreme Court, now resolved, the FAF is not aware of any significant legal impediment to governmental enforcement programs against insider trading abuses.

On the contrary, for example, the SEC in its report to the House Committee on Energy and Commerce on August 23, 1985, reviewing two years of enforcement activity after the Supreme Court decision in Dirks, stated that its effectiveness had not been reduced in any significant degree by that decision.[11] Moreover, since the Dirks decision, the courts have adopted the misappropriation theory which was continued in November by the Supreme Court in Carpenter. This theory has been the basis for many of the civil and criminal actions for insider trading abuses in the last few years.[12]

On the other hand, while criminal defense lawyers have been advocating a statutory definition of insider trading in the U.S.

11/ At 3 and 4.

12/ As far as the FAF can discover, the criminal decision in U.S. v. Reed (see, The Wall Street Journal, December 17, 1985), is the only case in many years where the decision might have been different had a statute existed such as the SEC Bill. Mr. Reed, prior to the jury verdict in his favor, had agreed to a court order in an SEC injunctive action. SEC LR-9537 (December 23, 1981). The case of SEC v. Switzer 590 F. Supp. 756 (D.C. Olka. 1984), was decided on its facts and not on legal principles.

House of Representatives,[13] none have made any presentations to this Subcommittee, to the FAF's knowledge. Nor has the FAF discovered any contentions by commentators to this Subcommittee, that any civil or criminal defendants have been inappropriately found in violation of the existing insider trading laws.

The FAF has observed that many respected, thoughtful and conscientious organizations and individual commentators, have conflicting views of the various versions of the proposed legislation.[14] Moreover, they differ considerably about the need for legislation.[15] None have stated, however to the FAF's knowledge, that the present state of the law restricts, in any significant degree, governmental enforcement programs against insider trading.

In short, the FAF is not persuaded that legislation is necessary, nor even desirable because of the considerable disagreement about the content of that legislation, at least to date.

III. FAF POSITION ON THE SEC BILL

Notwithstanding the noteworthy efforts of the SEC, the Ad Hoc Committee and others, it is the FAF's view that many important

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13/ Hearings of the House Subcommittee on Criminal Justice on H.R. 1238, The SEC Today, July 28, 1987, at 1 and 2.

14/ Many organization representatives and individual commentators advocating widely differing positions have held governmental positions most notably with the SEC.

15/ Op. cit. note 5.

deficiencies exist in the SEC Bill. The FAF made a number of recommendations in its Statement[16] most of which are applicable to the SEC Bill and which have not been adopted in the form suggested.

While the FAF clearly understands that it was not intended by the SEC and Ad Hoc Committee, it does believe that the SEC Bill and the Reconciliation Draft would potentially adversely affect the vital role of investment managers and securities analysts in the investment decision-making process,[17] and potentially act as a deterrent to the free flow of information.[18]

The SEC and Chairman Ruder have recognized this role[19] and the issues presented, for which the FAF is appreciative. However, the FAF is concerned that the proposed legislative history being prepared by the SEC to be included with a bill as adopted, will leave problem areas of interpretation in the act itself. While the use of legislative history is often helpful to provide background, elaboration and the rationale for a statutory

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16/ FAF Statement at 19 and 20.

17/ The FAF Statement explains at length the function and role of investment managers and securities analysts (at 20 and 25), and the recognition of that role by the courts and the SEC (at 25 to 29).

18/ See also, the statement of the Securities Industry Association at 2, 8 and 10, and the statement of Kenneth J. Bialkin at 7.

19/ Transmittal letter of Chairman David S. Ruder, November 18, 1987, at 2, 3 and 4; Statement of Chairman David S. Ruder, December 15, 1987, at 3, 4 and 12.

act (the FAF suggested its use for those purposes in its Statement),[20] courts may vary considerably on its use in applying the act.

The FAF is pleased that the Chairman has recognized the role of investment managers and securities analysts in his written submission to the Subcommittee and in his oral testimony on December 15, 1987,[21] and, it is expected, in the SEC proposed legislative history.[22] Nevertheless, the FAF believes that the legislation itself should contain the vital operative provisions rather than relying on the use of legislative history, rulemaking, and the granting of exemptions which the SEC Bill authorizes, all of which the SEC contemplates.[23]

The following sections briefly describe the FAF's principal concerns virtually all of which are described at greater length in the FAF Statement.

IV. COMMENTS ON THE SEC BILL

The FAF believes that the SEC Bill does not contain a number of provisions that it should contain, many of which are to be the subject of the SEC's submission on legislative history,[24] and

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20/ FAF Statement at 4, 6 and 17.

21/ 19 Sec. Reg.& L. Rep. 1923 (December 18, 1987).

22/ Op. cit. note 19, Transmittal letter of Chairman David S. Ruder.

23/ Op. cit. note 21, Statement of David S. Ruder at 12 and 15, and SEC Bill Section 16A(f)(i).

24/ Transmittal letter by David S. Ruder, November 18, 1987.

that there are a number of provisions in the SEC Bill which are troublesome.

The SEC Bill appears to cover a wide range of so-called "market information". The language and coverage is too sweeping and lacks provisions linking the information to a significant relationship to the securities markets. The language should be modified and should not be left to legislative history as suggested by the SEC.

The FAF in its Statement advocated that the statute be a "use" rather than "possession" statute.[25] S. 1380 as initially introduced, and the NYSE Bill, are both use statutes, while the SEC Bill and the Reconciliation Draft are possession statutes. The FAF believes that the adoption of a possession statute will very likely have adverse effects on the role of investment managers and securities analysts in the investment decision-making process and potentially will create a significant danger of impeding the highly desirable objective of the free flow of information in the investment process.

The FAF agrees with the separate statement submitted by former SEC Commissioner Richard B. Smith, noting that the concepts of wrongful use and wrongful obtaining of information are not clearly presented or defined in the SEC Bill. Moreover, the concept of "misappropriation" is not clearly set forth and omits crucial elements which the SEC proposes to explain in legislative history. These problems should be remedied.

25/ FAF Statement at 6, 11 and 19.

The FAF recommended in its Statement that any act contain a provision excluding utilization of the "mosaic theory" from coverage of the act and it submitted proposed language to do so.[26] While the FAF appreciates the several statements made by Chairman Ruder in his written submissions to the Subcommittee recognizing the importance of the work of investment managers and securities analysts, and his oral statements recognizing the validity of the mosaic theory,[27] the FAF strongly believes that an act should contain such a provision.

While the FAF also appreciates the undertaking by the SEC to include in the legislative history an explanation that many communications to and by investment managers and securities analysts are not within the coverage of the SEC Bill, provisions to that effect should also be included in any act.[28]

The FAF in its Statement advocated that any act should provide an affirmative defense for all persons, whether natural or non-natural, that the transaction was not influenced by material nonpublic information.[29] The approach in the SEC Bill requiring, in addition, lack of knowledge and the additional requirement that compliance procedures have been implemented are too restrictive and, the FAF believes, inappropriate. This is

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26/ FAF Statement at 4, 5, 15 to 17, and 20.

27/ 19 Sec. Reg. & 1 Rep. 1923 (December 18, 1987).

28/ See FAF Statement at 6, 12 and 19.

29/ FAF Statement at 13 to 16 and 20.

especially true as the content and extent of compliance procedures required by the Bill are very general.

The FAF believes that the insertion in the SEC Bill, in Section 16A(e), of the requirement that an employer not "profit from" a transaction by a controlled person to be exonerated from that person's conduct, is inappropriate and should be deleted.

The FAF believes that it is an appropriate use of legislative history to indicate that the typical relationship of an investment manager or securities analyst with an issuer or communicators of information is not a "relationship of trust and confidence" as that term is used in the SEC Bill.[30]

Finally, the FAF noted in its Statement that it favors a definition of materiality based on a "market impact" test.[31] The NYSE Act is premised on such a definition which has been utilized by the courts and the SEC in several decisions.[32] The FAF opposes a standard of materiality applicable to proxy statements under the Securities Exchange Act of 1934 or registration statements under the Securities Act of 1933, both of which have sometimes been mentioned in insider trading cases.

30/ FAF Statement at 12 and 19.

31/ FAF Statement at 17.

32/ Report of the New York Stock Exchange Legal Advisory Committee at 18 and 19. See also the Statement of Kenneth J. Bialkin at 6 and 7, and the FAF Statement at 17.

V. CONCLUSION

The FAF appreciates the opportunity to comment on proposed legislation under consideration by the Subcommittee and desires to continue to participate in the legislative process and to render any assistance that the Subcommittee and its staff might find useful.

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